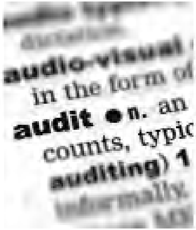
Qualification Programme

Module C: Business Assurance

FOURTH EDITION

CPA
Hong Kong Institute of Certified Public Accountants
香港會計師公會

QP
Hong Kong's CPA Qualification
香港會計師專業資格



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Module C

Business Assurance

Flashcards

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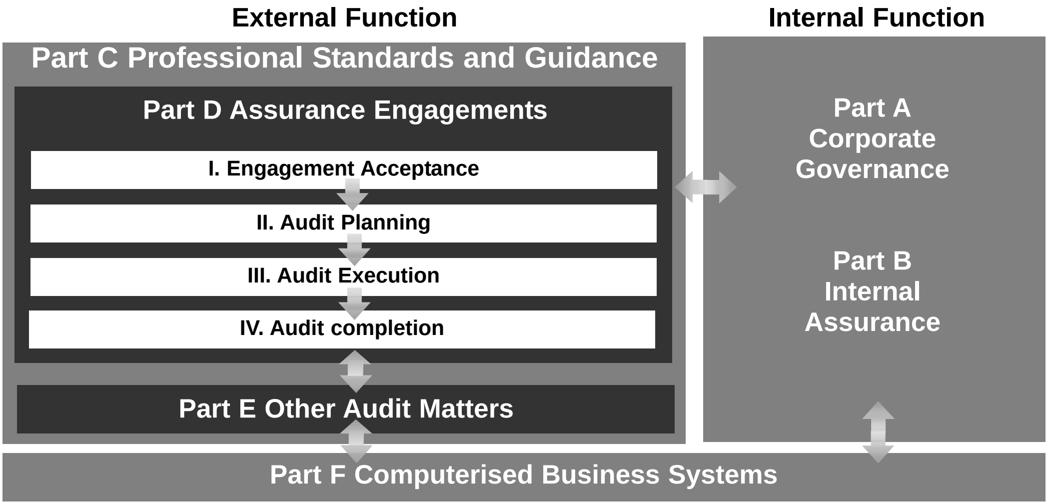
Welcome to the HKICPA Flashcards for Module C Business Assurance.

- They concentrate on the key topics you need for your exam preparation.
- They include **diagrams** to assist your memory.
- They follow the overall **structure** of HKICPA Learning Packs, but these Flashcards are not just a summarised book. Each card has been separately designed for clear presentation. Topics are self contained and can be grasped visually.
- The Flashcards are **just the right size** for pockets, briefcases and bags.

Run through the **Flashcards** as often as you can during your final revision period. The day before the exam, try to go through the **Flashcards** again! You will then be well on your way to passing your exams.

Good luck!

Overall structure of Module C



1: Scope of corporate governance

Topic List

- Codes
- Agency
- Stakeholders
- Major issues
- Corporate social responsibility

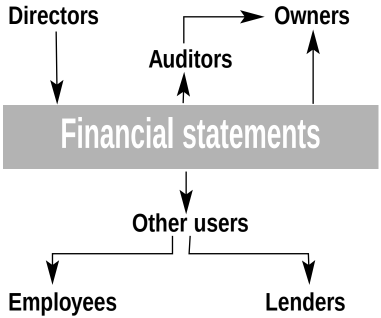
Corporate governance is the system by which a company is directed and controlled.

Corporate governance is ‘the system by which a company is directed and controlled’.

The problem of corporate governance

The problem of corporate governance arises because often in companies (particularly larger ones) management and owners are not the same people. The managers (stewards) of the company report to the owners. Other people use that report to draw conclusions about the company.

This ‘report’ (the financial statements) is audited by auditors, who report on their truth and fairness.



In the light of several frauds and malpractice in the 1990s, governments commissioned various reports which concluded:

- **Good practice is required**
- **Assurance on good practice is required**

Lead to corporate governance codes

Amendments have been made to HK Code to keep it in line with international best practice. The revised Code must be adopted from 1 April 2012.

Elements of corporate governance

- Management of risk ∴ control systems
- Overall performance well supervised/best practice
- Framework for ethical and efficient behaviour
- Willingness to apply the spirit of codes/regulations
- Attracts new investment
- Accountability to **all** stakeholders
- Underpins capital market confidence

OECD Principles of Corporate Governance

- Promote transparent and efficient markets, and consistent with law
- Protect shareholders' rights
- Equitable treatment of all shareholders
- Encourage co-operation between corporations and stakeholders
- Timely and accurate disclosure on all material matters
- Accountability to company and shareholders

Corporate governance concepts

Fairness

Balanced approach taking all with a legitimate interest in the company into account.

Independence

Introduction of independent non-exec directors - allowing effective (non-biased) monitoring.

Responsibility

Accepting blame/credit. System for holding management to account.

Reputation

Often a valuable 'asset' of the company.

Integrity

High moral character ... straightforward dealing ... personal honesty and integrity.

Transparency/openness

Open and clear disclosure of relevant information to shareholders/other stakeholders.

Probity/honesty

Telling the truth and not being misleading.

Accountability

See page 6.

Judgment

Making decisions that enhance the prosperity of the organisation; risk management.

HKICPA Corporate Governance Disclosure in Annual Reports (March 2001)

- Statement on corporate governance - **Recommended** in Annual Report
- Directors' remuneration - Disclosure **required** + share options
- Non audit fees paid to the auditors - Disclosure **required**

HKICPA Corporate Governance for Public Bodies - A basic framework (May 2004)

- Identifies fundamental principles (eg openness, integrity, accountability)
- Standards of behaviour (Codes of Conduct)
- Organisational structures and processes
- Risk management and controls
- Accounting, reporting and disclosure

HKICPA Internal Control and Risk Management (June 2005)

HKICPA Defining and Developing an effective code of conduct for organisations (December 2008)

There are many people interested in the financial statements of a company. They are called **stakeholders**.

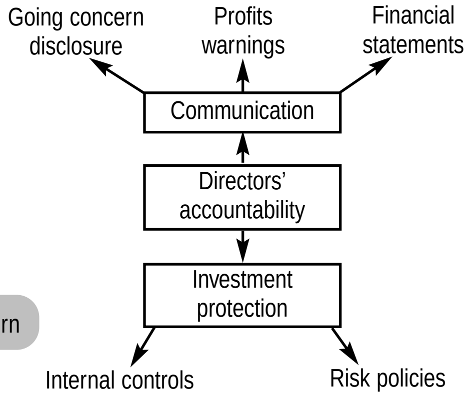
Particularly in larger companies, the **owners of a company and the management of that company are distinct.** Shareholders are the key stakeholders.

Directors are **accountable** to the shareholders in their role as **stewards** and **agents**. Accountable means being required to justify actions and decisions.

What are directors accountable for?

Shareholders' investment → expectation of future return

Accountability covers a range of issues.



Aim is to align the interests/risk management of parties, eg profit incentive for managers.

Classification of stakeholders

Stakeholder group	Members
Internal	Employees/management
Connected	Shareholders/customers/suppliers/lenders/trade unions/competitors
External	Government/local government/public/pressure groups/opinion leaders

Can be a clash between needs of shareholders and other stakeholders

shareholders ↓ return on investment

other stakeholders ↓ social consequences

Managers (**agents** of shareholders) have to balance the needs of their principal (shareholders) with other stakeholder needs, and moral obligations.

Directors

- Duties: fiduciary/proper purpose/duty of care
- Balance of the board
- Remuneration/rewards
- At least one-third of board must be INEDs

Financial reporting

- Need for greater transparency
- Enforcing independence of auditing in practice

Shareholders

- Rights and **responsibilities** (to vote)
- Role of institutional investors
- Shareholder rights information must be disclosed

Corporate social responsibility

- Economic responsibilities
- Legal responsibilities
- Ethical responsibilities
- Philanthropic responsibilities (desirable)

(see page 9).

Caroll and Bucholtz identified four layers of corporate social responsibility.

Economic	**Legal**	**Ethical**	**Philanthropic**
To shareholders and to employees Economic reasons are fundamentally why businesses exist.	Obeying the law is the foundation of compliance with social responsibilities.	Always act fairly and justly – whether the law requires it or not.	Desired but not required, for example charitable donations.

How 'good' a corporate citizen do we want to be?

Notes

2: Corporate governance reports and practice

Topic List

A question might require assessment of the corporate governance arrangements in place in a given organisation.

Codes of Best Practice for corporate governance are increasingly common worldwide. The UK **Corporate Governance Code** represents best practice.

The UK Code

The UK Code brings together recommendations of various committees. It is primarily relevant to listed companies although considered best practice for all companies. It is **voluntary** although UK listed companies must report on non-compliance.

Voluntary codes

Advantages

- Can be applied flexibly
- Smaller entities can pick and choose
- Does not create 'burden of requirement'

Disadvantages

- Insufficient protection
- Choice of non compliance

The UK Corporate Governance Code

The **UK's Code** applies to all **UK listed companies,** but other companies are also encouraged to follow it.

Any **departures** from the Code by listed companies should be **disclosed and explained.**

Key principles of the Code

■ **Leadership**	Every company should be headed by an effective board, including clear division of responsibility between running the board and running the company.
■ **Effectiveness**	The board should have an appropriate balance of skills, experience, independence and knowledge.
■ **Accountability**	The board should present a balanced and understandable assessment of the company's position and prospects.
■ **Remuneration**	Should be sufficient to attract, retain and motivate directors of sufficient quality. A significant proportion of remuneration should be linked to performance.
■ **Relations with shareholders**	There should be a dialogue with shareholders based on mutual understanding of objectives.

The Board

- Meets regularly
- Balance of execs/non-execs
- Some non-execs to be independent
- Rigorous/transparent nomination process
- Directors to submit for re-election

Chairman

- Roles of Chairman/Chief Exec to be distinct

Internal controls

- Board should maintain sound system

Audit committee

- Should be established

Internal audit

- Consider the need for an internal audit function annually

Factors to consider in whether a director is independent

- Has been an employee of company/group in the last five years?
- Has, or has had, a material business relationship with the company in the last three years?
- Receives, or has received, additional remuneration from the company (including share options and pensions)?
- Has close family ties with directors?
- Has significant links with other directors?
- Represents a significant shareholder?
- Has served on the Board > 9 years?

Hong Kong Code

- Comply or explain approach

Directors

- Chairman/CEO separate
- Balance of board (exec/non-exec)
- Transparent procedure for appointment
- Re-election at regular intervals
- Shareholder vote re INED > 9 years
- Responsible for corporate governance

Remuneration of directors/senior management

- Transparent procedure
- Sufficient to attract/motivate
- Performance linked
- Disclosure required

Delegation by board

- Clear direction
- Division of responsibility of directors/mgmt

Board diversity

From September 2013 listed companies must observe the provisions arising from the HKEx paper on Board Diversity

Accountability/financial reporting/audit

- Present balanced/clear/comprehensive report
- Sound internal control
- Clear terms of reference for audit committee

Communications with shareholders

- Maintain ongoing
- Encourage participation (through website)

Company secretary

- Supports Chairman/facilitates effective functioning of Board
- Selection/appointment/dismissal is board decision

Company **required** to report on some aspects of CG, other aspects are **voluntary**. Auditors required to check mandatory aspects.

Audit committees

Advantages

- Increased confidence in credibility of reporting
- Frees executive directors to manage
- Reporting lines for internal audit/impartial link for external audit
- Creates culture opposed to fraud

Disadvantages

- Selecting suitable independent non-executive directors can be difficult
- Formality may dissuade reporting on judgemental issues
- Cost of audit committee

Duties

Liaison with external auditors

- Determine scope of external audit
- Forum to link directors/auditors
- Deal with auditors' reservations
- Obtain information for auditors
- Meet at least twice a year

Review of internal audit

Review of internal controls

Special investigations

3: Internal assurance

Topic List

Internal assurance relates both to the wider principles of corporate governance discussed in the first two chapters, and also to the role of internal audit.

Directors

Internal controls and risk management are very important in fulfiling directors' duties to the shareholders, which are:

- To safeguard the assets
- To prevent and detect fraud

Protect the investment of the shareholder

Therefore they:

- Set up a system of internal control
- Review its effectiveness
- Consider the need for internal audit

Auditors

As part of their audit:

- Ascertain controls
- Review controls
- Evaluate controls
- Determine audit approach based on controls

Can also offer services:

- To review controls
- Report to shareholders

as a function separate from audit

HKEX requires that a listed company's internal control system is reviewed regularly by management and internal audit.

UK *Internal Control: Guidance to directors* (also known as Turnbull guidelines) relating to:

- Internal controls
- Managing risks
- Monitoring

Internal auditors have a role in assisting directors, particularly with regard to internal controls and monitoring.

Internal audit is an appraisal or monitoring activity established by management and directors, for the review of internal control as a service to the entity. It functions by examining, evaluating and reporting to management and the directors on the adequacy and effectiveness of internal control. It is a key element of effective corporate governance.

Internal auditors and risk management

Directors need to take three steps in their business:

1. Identify risks
2. Control risks
3. Monitor risks

Outsourcing internal audit

Advantages

- Service provider has good quality staff
- Has specialist skill
- Can direct their own work and educate management as to the service required
- Provides immediate team
- Can be appointed for appropriate timescale
- May cost less than setting up a department
- Can be used on a short-term basis

Disadvantages

- Independence issue if audit firm provides service
- Cost may result in director choosing not to have an internal audit function
- May result in staff redundancies
- Extended time frame between set up and results
- Outsourced staff may have limited knowledge of the company
- In-house skill and expertise will be lost

The work of internal audit also has relevance for the external auditor.

HKSA 610 (Revised 2013) *Using the work of internal auditors* provides guidance in this area.

The external auditor must consider:

1. Whether, and to what extent, the work of the internal audit function or direct assistance from internal auditors may be used.
2. The nature and extent of work that can be used.

If the auditors decide to make use of the work of internal audit function, they must **evaluate** that work. Reperformance of some work is required.

The important criteria are **organisational status, level of competence and nature of approach including quality control.**

	Internal audit	**External audit**
Objective	Adds value	Express an opinion
Reporting	To board of director / audit committee	Shareholder
Scope	Relates to operations	Relates to financial statements
Relationship	Employee / outsourced	Independent

Mandatory for companies required to file reports with US Securities and Exchange Commission therefore affects some HK companies. Key provisions include:

- **Public Company Accounting Oversight Board** (PCAOB) set up. Powers to set auditing, QC, independence and ethical standards and to regulate the non-audit services that firms can offer.
- **Auditing standards**: Retain working papers 7 years, have QC standards, review IC as part of audit.
- **Non-audit services**: Several are prohibited to auditors of companies.
- **Quality control procedures**: Rotation of lead/reviewing audit partners every 5 years. Other independence requirements, consultation, supervision, professional development.
- **Audit committees**: All listed entities should have one, members must be independent. Responsible for appointment, compensation and oversight of auditors.
- **Auditors** to discuss critical accounting policies, possible alternative treatments, management letters and unexplained differences with the audit committee.
- **Corporate responsibility**: CEO and CFO to certify appropriateness of FS.
- **Off balance sheet transactions** should be disclosed appropriately.
- **Internal control reporting** - contained in annual report.
- **Whistleblower protection** offered to employees.

4: Code of Ethics

Topic List

You must understand the principles-based approach to ethics and be familiar with the guidance issued by HKICPA.

*In the exam you are likely to be faced with scenarios where you have to **apply** your knowledge, identify ethical **threats** and recommend appropriate **safeguards**.*

HKICPA *Code of Ethics for Professional Accountants*

The code takes the form of a conceptual framework, setting out five fundamental principles. This recognises that it is impossible to define every situation that may give rise to specific threats, and to prescribe specific safeguards appropriate to widely differing engagements.

Integrity

A professional accountant should be straightforward and honest in all professional and business relationships.

Objectivity

A professional accountant should not be biased, nor have conflicts of interest or undue influence to override professional or business judgments due to bias.

Professional competence and due care

A professional accountant should be competent to perform professional services and should act diligently and in accordance with applicable technical and professional standards.

Confidentiality

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information should not be used for personal advantage or for any third parties.

Professional behaviour

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

HKICPA code was revised in June 2010 and February 2012.

Threats

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances:

Threats

- **Self-interest** threat — financial or other interests of the accountant or close family members
- **Self-review** threat — data being reviewed by the same person responsible for preparing it
- **Advocacy** threat — a professional accountant promoting a position/opinion that subsequently compromises objectivity (eg promoting shares)
- **Familiarity** threat — a professional accountant becomes too sympathetic to the interests of others due to a close relationship
- **Intimidation** threat — when a professional accountant is deterred from acting objectively by actual or perceived threats

Safeguards

Three categories of safeguards exist: those created by regulations, those created by the individual and those created in the work environment.

Regulations

- Training requirements
- Professional standards

Individual

- Complying with continuing professional development requirements
- Keeping records of contentious issues and decisions
- Using an independent mentor
- Maintaining contact with legal advisers and professional bodies

Work environment

- Recruitment procedures
- Appropriate disciplinary processes
- Leadership that stresses the importance of ethical behaviour
- Policies and procedures to implement and monitor the
  - quality of employee performance
  - quality control of engagements
- Using different partners and teams for the provision of non-audit services to assurance clients
- Discussing ethical issues with those charged with governance
- Consultation with another professional accountant

Independence: S290 – Independence – Audit and Review Engagement
S291 – Independence – Other Assurance

Independence of mind is the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.

Independence in appearance is the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances that a firm's/member of audit team's integrity, objectivity or professional scepticism has been compromised.

Objectives of this section of the HKICPA code:

Aims to help firms and members:

1. Identify threats to independence
2. Evaluate the significance of the threats identified
3. Apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level

Accountants owe their clients a **professional duty of confidence**, except in the following situations:

Obligatory disclosure

If a member knows or suspects his client to have committed a default or a criminal act he is obliged to disclose all the information at his disposal to a competent authority.

Voluntary disclosure

In certain cases voluntary disclosure may be made by the member where:

- Disclosure is required to protect the **member's interests**
- Disclosure is required by **law/statute**
- It is in the **public interest** to disclose
- Required by non-governmental bodies

HKICPA Code

- To comply with technical/ethical standards
- To comply with quality review
- To respond to enquiry by HKICPA
- To enable member to sue for fee
- To resist an action for negligence

Conflicts between members'/ entity's interest

Members and firms should not accept or continue engagements in which there are, or are likely to be, significant conflicts of interest between members, firms and entities.

Conflicts between the interests of different entities

Acceptable to have two clients in dispute, so long as work of the firm is not the subject of the dispute. However, where acceptance or continuation of engagement would, even with safeguards, materially prejudice the interest of any entity, the appointment should not be accepted or continued.

Other issues

Marketing

Should be honest and truthful...not make disparaging references to other accountants

Inducements

= self-interest threat. DO NOT ACCEPT if offered inducement by professional accountant...inform management/professional body

Asset custody

An accountant should only take custody of client assets where allowed to do so and then keep them separate from own assets

Insolvency

No partner/employee of firm should accept appointment as receiver/manager/trustee/liquid-ator in bankruptcy **if** there is a **material professional relationship**

5: Framework for assurance engagements

Topic List

- Assurance engagements
- External audit
- Reviews/other assurance
- Non-assurance

This chapter looks at the basis of auditing and how it differs from other assurance engagements.

Please refer to your Learning Pack to see the list of standards applicable to audit and assurance.

An **assurance engagement** is one where a **practitioner** expresses a conclusion designed to enhance the degree of confidence of the **intended users** other than the **responsible party** about the outcome of the evaluation or measurement of a subject matter against criteria.

Why have an assurance engagement?

- Enhance credibility of information
- Improve likelihood users' needs will be met

Elements

Subject matter

- Identified
- Specific time period
- Data/processes/behaviour
- Financial or non-financial

Criteria

Characteristics:

- Relevance
- Completeness
- Reliability
- Neutrality
- Understandability

Assurance given

A **reasonable** level of assurance can be given as the accountant is evaluating specific criteria. Absolute assurance cannot be given. Limited assurance is given as negative assurance (nothing suggests otherwise ...).

Evidence

- Gain sufficient appropriate evidence
- Sufficient = quantity
- Appropriate = quality

Not assurance engagements

- Agreed-upon procedures
- Compilations

See page 38

- Tax return preparation
- Management/tax consulting
- Other advisory services

Reporting

- Express opinion giving reasonable/limited level of assurance
- Negative assurance reported for limited assurance assignment

An **audit** is an exercise whose objective is to enable auditors to express an opinion whether the financial statements (FS) are prepared, in all material respects, in accordance with an applicable financial reporting framework, **giving a true and fair view**.

HKSA 200 (Clarified)

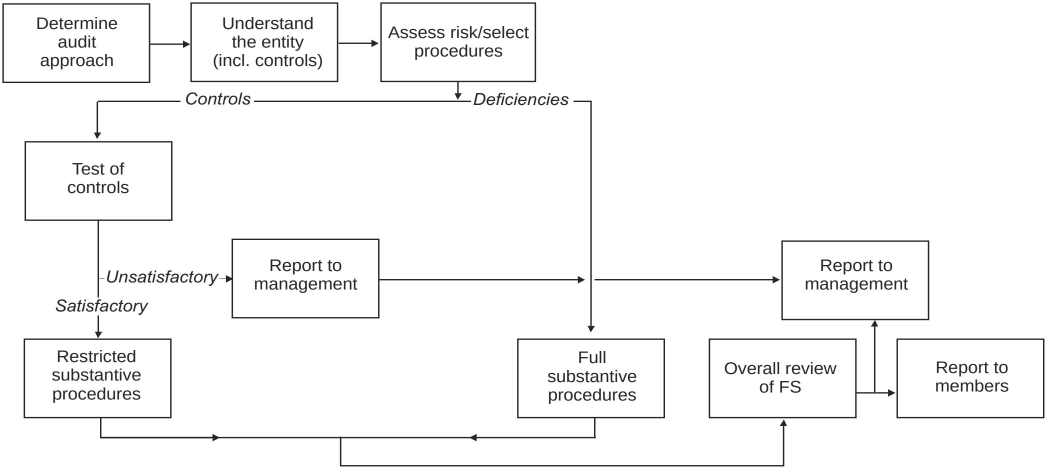
- Reasonable assurance
- Mandatory for companies incorporated under HK Companies Ordinance

True: Information is factual and conforms with reality; not false. In addition it conforms with required standards and law. The accounts have been correctly extracted from the accounting records.

Fair: Information is free from discrimination and bias and in compliance with expected standards/ rules. The accounts reflect the commercial substance.

Auditors do not bear any responsibility for the **preparation and presentation** of the financial statements, which is the **responsibility of the directors.**

Audit process



Professional scepticism

Never assume management is dishonest but approach audit with questioning mind.

Reasonable assurance is not a guarantee of correctness, but an assurance of truth and fairness within a reasonable margin of error.

Materiality

Misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users of FS.
Judgments about materiality are affected by the size and/or nature of a misstatement.

Limitations of an audit

- Audit judgements
- Not all items in FS checked
- Limitations of systems
- Chance of collusion in fraud
- Time lag (period – reporting)
- Limitations of the audit report

The objective of a **review engagement** is to enable an auditor to give an opinion whether anything has come to his attention that would mean the FS were not properly prepared/true and fair, **on the basis of procedures which would not constitute an audit.**

HKSRE 2400 (Revised) *Engagements to Review Historical Financial Statements* applies

Also

- Assurance engagements not dealing with historical financial information: HKSAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information*
- Reporting on the compilation of Pro Forma financial information:

  HKSAE 3420 *Assurance Engagements to Report on the Compilation at Pro Forma Financial Information included in a Prospectus* (also HKSIR 300)

Engagement	Type of assurance provided	Examples
Agreed-upon procedures	None	Examination of statement of financial position – factual findings Examination of segmental sales and profit – factual findings
Compilations	None	Preparation of financial statements Preparation of tax returns

6: Quality control

Topic List

Audit quality is about delivering an appropriate audit opinion. Many principles contribute to audit quality and HKICPA has issued two standards that set out principles applicable at a firm level and at an individual audit level.

HKSQC1 (Clarified) gives guidance about quality control at a firm level.

The objective of the firm is to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances.

Leadership responsibilities

- Sufficient and appropriate experience
- Ability to carry out the job
- Authority to carry out the job

Ethical requirements

- Policies and procedures (see chapter 4)

Human resources

- Recruitment
- Capabilities
- Career development
- Remuneration
- Performance evaluation
- Competence
- Promotion
- Estimation of personnel needs

The assignment of engagement teams is the responsibility of the engagement partner.

Engagement performance

This involves:

- Direction
- Supervision
- Review
- Consultation
- Quality control review

These matters are looked at in detail at an assignment level (HKSA 220 Clarified)

Acceptance and continuance

- Policies and procedures (see chapter 7)

Monitoring

QC procedures must be:

- Relevant
- Adequate
- Operating effectively

Corrective action includes:

- Remedial action with individual
- Communication with training dept.
- Changes in QC policies and procedures
- Disciplinary action (if necessary)

HKSA 220 (Clarified) *Quality control for an audit of financial statements* applies the general principles of HKSQC 1 (Clarified) to individual audits.

Individual audits

- Leadership – engagement partner responsible
- Adhering to ethical requirements (independence and objectivity)
- Acceptance/continuance of audit
- Appropriately qualified/experienced staff
- Engagement performance
- Monitoring QC procedures

Engagement performance

- **Direction**. Informing staff about:
  – The work to do
  – Nature of client
  – Potential problems
  – Responsibilities
- **Supervision**. Overall by engagement partner but more practical supervision given within the audit team
- **Review**. Includes consideration of whether:
  – Work complies with required standards
  – Significant matters/conclusions documented
  – Evidence is sufficient and appropriate
- **Consultation**. Contentious matters must be discussed and properly reviewed
- **Quality Control review**. Evaluation of:
  – Significant judgements
  – Conclusions

7: Changes in auditor appointment

Topic List

It is important for auditors to understand the legal rules and ethical principles surrounding a change in auditors. An engagement letter is a vital document, setting out the agreement and also confirming the nature of the engagement for the client.

Hong Kong Companies Ordinance

- Directors appoint auditors within three months of incorporation
- Thereafter, auditors appointed annually at AGM (by shareholders)
- Directors may appoint to fill casual vacancy

Auditor needs to ensure he is qualified (holds a practising licence).

To change an auditor:

Special notice required to

- appoint auditors other than retiring auditors
- fill a casual vacancy
- reappoint auditors appointed to fill a casual vacancy
- remove auditors before expiration of office (special notice + ordinary resolution).

Rights of outgoing auditor (retiring or being removed)

- New Companies Ordinance gives duty to make a statement of circumstances in case of retirement or removal
- Can make written representations to entity
- Can request written representations sent to all members
- Can request representations **read out** at general meeting
- Can attend meetings concerning matters relevant to them as auditors
- Can receive all notices relating to such meetings

Resignation of auditor

- Deposit notice in writing at registered office
- With signed statement of (no) circumstances
- Request directors to convene EGM to explain resignation
- Directors have 21 days to call meeting or statement can be circulated to members

Rights and duties

The overriding duty of the auditors is to report on the truth and fairness of the FS. This is a duty owed to shareholders.

The auditors have **statutory rights**, as well:

Statutory rights

- A **right of access** at all times to the books, accounts and vouchers of the company
- A **right to require** from the company's officers such **information and explanations** as they think necessary for the performance of their duties as auditors
- A **right to attend any general meetings** of the company and to receive all notices of and communications relating to such meetings relating to the auditor

New Companies Ordinance

- Will come into operation in 2014
- Has the effect of strengthening auditor rights to require information and exploration

Before acceptance

The auditors should:

- Ensure professionally qualified to act.
  - Consider whether disqualified on legal or ethical grounds
- Ensure existing resources adequate.
  - Consider available time, staff and technical expertise
- Obtain references.
  - Make independent enquiries if directors not personally known (client screening)
- Communicate with present auditors.
  - Enquire whether there are reasons/circumstances behind the change which the new auditors ought to know, also as a courtesy (with client permission)

After acceptance

The auditors should:

- Ensure outgoing auditors' removal/resignation properly conducted.
- Ensure the new auditors' appointment is valid.
- Set up and submit a letter of engagement.

Factors for consideration in client screening

- Management integrity
- Risk
- Relationships
- Ability to perform the work
- Engagement economics

High risk	Low risk
Poor performance	Good prospects
Lack of finance	Well-financed
Odd accounting	Strong controls
Lack of finance director	Prudent accounting
Significant related party/ unusual transactions	Competent directors
	No unusual transactions

Sources of information about new clients

1. Enquiries of other sources (bankers, solicitors)
2. Review of documents (most recent annual accounts, listing particulars, credit rating)
3. Previous auditors (previous auditors should disclose fully all relevant information)
4. Review of rules/standards (consider specific laws/standards that relate to industry)

The **audit engagement letter** is the written terms of an engagement in the form of a letter

Guidance on engagement letters is given in HKSA 210 (Clarified). *Agreeing the terms of audit engagements*. It applies to audit assignments ONLY.

HKSA 210 (Clarified)

The auditor must confirm there is a common understanding between the auditor and the client on the terms of the engagement.

The engagement letter must be sent prior to work starting on first audit, and subsequently where there has been a change of circumstances.

The audit engagement letter

- Confirm auditor's acceptance
- Objective and scope of the audit
- Auditor's responsibilities
- Management's responsibilities
- Identification of applicable financial reporting framework
- Expected form and content of any report
- Minimise misunderstandings
- Confirm fee basis

Additional matters that can be included in the engagement letter

- Elaboration of scope
- Form of any other communication
- Unavoidable risk of not detecting some material misstatements
- Expectation of provision of written representations
- Additional work expected from auditor
- Fees and basis of charge
- Irregularities and fraud
- Effective date of engagement letter
- Letter of acknowledgement from the board

Audit documentation => must be prepared on a timely basis.

Should include

- nature, timing and extent of audit procedures
- results of audit procedures
- significant matters

Audit working papers are owned by the auditor.

If the previous auditor has fees outstanding, he may exercise a lien (although rare).

A lien is a supplier's right to retain possession of a customer's property until the customer pays what is owed to the supplier.

8: Planning, materiality and risk assessment

Topic List

Planning sets the direction of the audit, based on risk assessment.

Benefits of planning:

1. To help the auditor to devote appropriate attention to important areas
2. To help identify and resolve potential problems on a timely basis
3. To perform the audit in an effective manner
4. To assist in selecting appropriate team members and in assignment of work
5. To facilitate the direction, supervision and review of work
6. To assist in co-ordination of work done by auditors of components and experts

HKSA 300 (Clarified) *Planning an audit of financial statements* identifies key activities as:

- preliminary engagement activities (procedures re continuance/ethics/terms)
- planning activities (which establish audit strategy and audit plan)

The **audit strategy** sets the scope, timing and direction of the audit, and guides the development of the detailed audit plan.

The **audit plan** converts the audit strategy into a more detailed plan and includes the nature, timing and extent of audit procedures in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

Audit strategy: matters to consider

- Characteristics of the engagement
- Reporting objectives, timing of audit and nature of communications
- Significant factors, preliminary engagement activities, and knowledge gained on other engagements
- Nature, timing and extent of resources

The audit plan must include the following:

1. Nature, timing and extent of planned risk assessment procedures
2. Nature, timing and extent of further audit procedures at assertion level
3. Any other planned audit procedures required to comply with HKSAs

The audit strategy and audit plan must be updated and changed as necessary during the course of the audit, with any changes, and reasons for them, documented.

Planning should only take place when the terms of the engagement have been agreed. **Preconditions for audit** must be present.

HKSA 315 (Revised) *Identifying and Assessing the risks of material misstatement through understanding the entity and its environment* provides guidance.

Risk assessment

The auditor shall perform a risk assessment to provide a basis for the identification and assessment of risks of material misstatement.

The engagement team shall discuss the susceptibility of the entity's financial statements to material misstatements and the application of the applicable financial reporting framework to the entity's facts and circumstances.

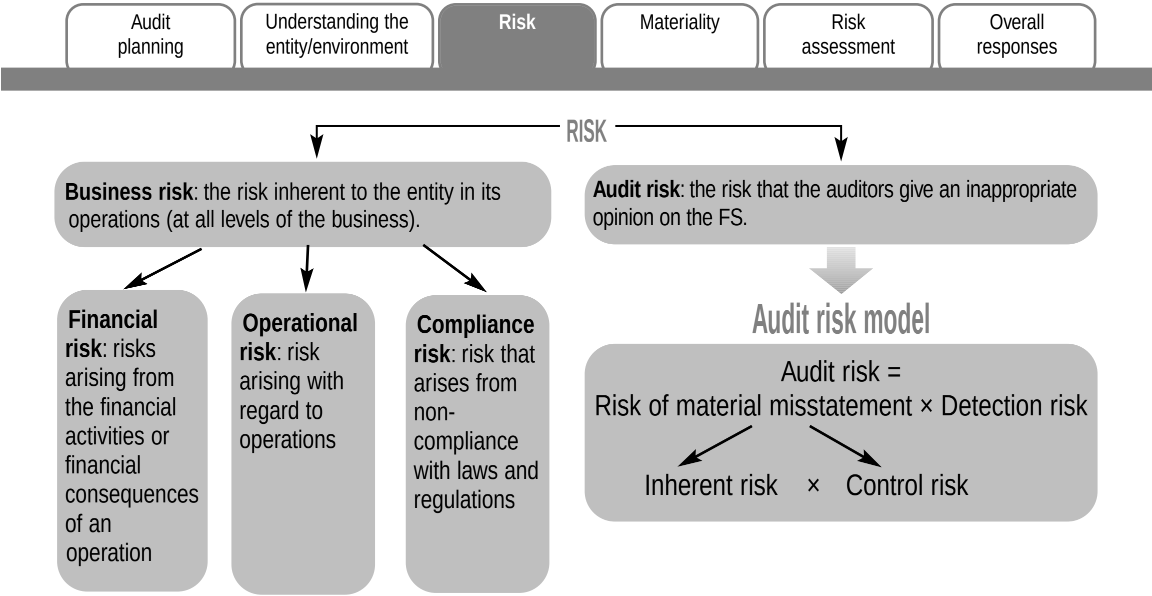
Risk assessment procedures shall include:

- **Inquiries** of management/others in entity including the internal audit function.
- **Analytical procedures**
- **Observation** and **inspection**

The auditor may also perform other procedures where circumstances merit it.

Matters to gain understanding of (from HKSA 315 Revised)

- Relevant industry, regulatory and other external factors including applicable reporting framework
- Nature of the entity
- Selection, application and suitability of accounting policies
- Entity's objectives and strategies and related business risks that could lead to material misstatement
- Measurement and review of the entity's financial performance
- Internal control relevant to the audit
- Control environment
- Entity's risk assessment process
- Information system relevant to financial reporting
- Entity's communication of financial reporting matters
- Control activities relevant to the audit
- Activities to monitor internal control over financial reporting


Audit planning
Understanding the entity/environment
Risk
Materiality
Risk assessment
Overall responses
RISK
Business risk: the risk inherent to the entity in its operations (at all levels of the business).
Financial risk: risks arising from the financial activities or financial consequences of an operation
Operational risk: risk arising with regard to operations
Compliance risk: risk that arises from non-compliance with laws and regulations
Audit risk: the risk that the auditors give an inappropriate opinion on the FS.
Audit risk model
Audit risk =
Risk of material misstatement × Detection risk
Inherent risk × Control risk

The components of audit risk

Inherent risk is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Control risk is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control.

Detection risk is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements.

Significant risks

- Non routine transactions (unusual due to size or nature)
  - More management intervention
  - Complex accounting principles/calculations
  - Manual intervention for data collection/processing
  - Controls overridden?
- Judgmental matters
  - Accounting estimates
  - Revenue recognition
  - Subjective/complex judgements
  - Assumptions required?

Materiality

Guidance on materiality for the financial statements as a whole, and on performance materiality is given in HKSA 320 (Clarified). Materiality in planning and performing an audit.

The auditor must determine:

- Materiality for the financial statement as a whole
- Performance materiality

Information is **material** if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and/or nature of a misstatement.

Performance materiality is the amount/amounts set by the auditor at less than materiality for the financial statements as a whole, to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

Assessing risk

HKSA 330 (Clarified) *The auditor's responses to assessed risks* requires the auditor to obtain sufficient appropriate audit evidence regarding assessed risks by designing and implementing appropriate responses.

Financial statement level possible responses

- Emphasise professional scepticism to team
- Assign more experienced staff
- Provide more supervision
- Incorporate more unpredictability into testing
- Make general changes to nature, timing or extent of audit procedures

Reducing risk

To reduce audit risk to an acceptably low level, the auditor must determine overall responses to the assessed risks at the financial statement level and must design and perform further audit procedures to respond to assessed risks at the assertion level.

Assertion level possible responses

Design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement, eg **substantive procedures** only, or a combined approach (**tests of control and substantive procedures**). (See chapters 11/12.)

9: Audit evidence, procedures, audit methodologies and audit sampling

Topic List

- Audit evidence
- Financial statement assertions
- Audit methodologies
- Sampling
- Documentation

Evidence is what is obtained in order to give the audit opinion. Here we look at what it is, and how to obtain it.

Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the audit opinion is based.

HKSA 500 (Clarified) *Audit evidence* gives guidance:

Auditors must design and perform audit procedures to obtain **sufficient appropriate** audit evidence.

Sufficiency

Quantity

Influenced by:

- Risk assessment
- Nature of systems
- Materiality of item
- Experience
- Source and reliability
- Results of **procedures**

Appropriateness

Quality

External evidence (more reliable than internal)
Auditor evidence (collected by auditors better than obtained from entity)
Entity evidence (more reliable when controls effective)
Written evidence (more reliable than oral)
Original evidence (original better than photocopies)

Audit procedures

These are carried out to:

- Obtain an understanding of the entity and its environment to assess risks (**risk assessment procedures**).
- Test operating effectiveness of controls (**tests of controls**). (Chapter 11)
- Detect misstatements (**substantive procedures**). (Chapter 12)

Audit procedures

- Inspection of tangible assets
- Inspection of documentation or records
- Observation
- Inquiry
- Confirmation
- Recalculation
- Reperformance
- Analytical procedures

Financial statement assertions are the representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Assertions

- About **classes of transactions and events**

  (occurrence, completeness, accuracy, cut-off, classification)
- About **account balances** at the period-end

  (existence, rights and obligations, completeness, valuation and allocation)
- About **presentation and disclosure**

  (occurrence, rights and obligations, completeness, classification and understandability, accuracy and valuation)

HKSA 315 (Revised)

The auditor shall obtain an understanding of whether the entity has a process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks.

Business risk approach

- Recognises that most business risks will eventually have an effect on the financial statements
- Allows the auditor to gain a greater understanding of the business and therefore increases the chance of identifying risks of material misstatement
- Enables auditor to give constructive business advice

Examples of business risks		Financial statement risks
Economic pressures causing reduced unit sales and eroding margins	→	Inventory values Going concern
Customer dissatisfaction related to inability to meet order requirements	→	Going concern
Economic pressures resulting in demands for extended credit	→	Receivables' recoverability

'Top-down' approach

Business

↓

Financial statements

The approach starts with the business and its objectives and works back down to the financial statements.

Impact of approach on procedures

Controls testing: Auditor concentrates on more high level controls used by directors to manage risks.

Analytical procedures: Higher use than in traditional audit (consistent with desire to understand the entity).

Detailed testing: Reduced due to the two factors above but not eliminated.

Top down approach

Advantages

- Added value to client as business focused
- Audit efficiency increased/cost is reduced
- Focuses on corporate governance
- Lower engagement risk as the auditor understands the clients' business

Systems audit

Auditors always ascertain and evaluate the systems of an audit entity. If auditors conclude systems are:

- **Effective**, they will undertake tests of controls and aim to reduce substantive testing
- **Ineffective,** they will not test controls and will undertake detailed substantive testing instead

Exam focus

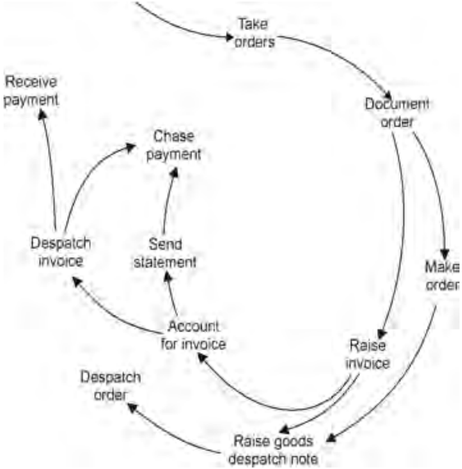
If auditors have judged that systems at a client are ineffective, they may choose the transactions approach to the audit so that the transactions which have gone through the weak systems can be substantiated.

REMEMBER

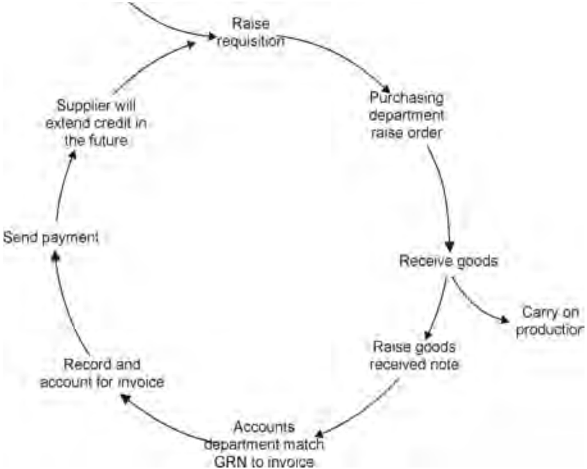
Substantive testing can **never** be eliminated entirely from an audit.

Transaction cycles approach:
When auditors take a cycles approach they test the **transactions** which result in statement of profit or loss entries. They will trace transactions through the system from order to payment.

Sales



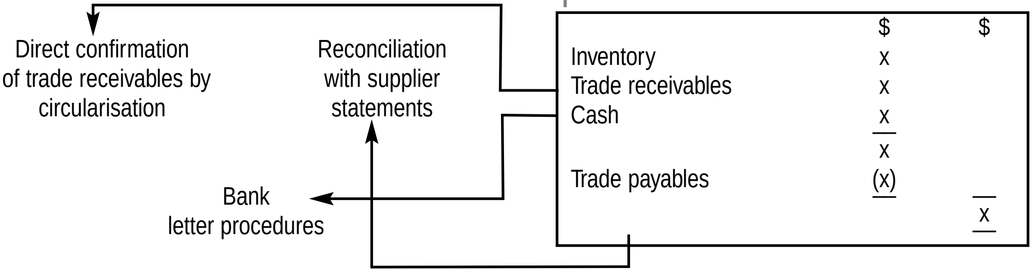
Purchases



The **balance sheet approach** is the most common approach to the substantive part of the audit. Auditors substantiate figures appearing in the statement of financial position, having ensured that the previous statement of financial position (similarly substantiated) has been used correctly as the opening position in the year.

Examples of substantive testing

Extract from a statement of financial position



Intervening transactions can be tested in less detail, say by analytical procedures.

Directional testing is an approach to testing used within a substantive approach. It is a methodology which gives assurance using the double entry accounting system.

		Primary test also gives comfort on			
Type of account	**Purpose of primary test**	**Assets**	**Liabilities**	**Income**	**Expenses**
Assets	Overstatement (O)	U	O	O	U
Liabilities	Understatement (U)	U	O	O	U
Income	Understatement (U)	U	O	O	U
Expenses	Overstatement (O)	U	O	O	U

Summary

The auditor will choose the audit approach which best fits the situation at the client, but may use a combination of the approaches discussed here. Therefore, directional testing can be used in a cycles or balance sheet approach, an analytical approach can be used with a business risk approach, etc.

Audit sampling is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection. It uses either statistical sampling or non-statistical sampling methods.

HKSA 530 (Clarified) *Audit sampling* provides guidance.

Design of sample – factors to consider

- Purpose of audit procedure
- Characteristics of population

Designing sample size

The auditor must design a sample size sufficient to reduce sampling risk to an acceptably low level.

Selection

- **Random** (all items have equal chance of selection)
- **Systematic** (constant interval between items)
- **Haphazard** (chosen at will, but guarding against bias in the selection)
- **Block** (check if items have particular characteristics)

Sampling risk arises from the possibility that the auditor's conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to sampling risk (eg using inappropriate audit procedures).

Evaluation

Auditors must analyse any deviations or misstatements in the sample and draw inferences for the population as a whole.

Qualitative aspects of the misstatement should be considered (nature of error/balance). Misstatements may be **projected** against the whole balance of the population.

Summary

- Determine objectives and characteristics of population
- Determine sample size
- Choose method of sample selection
- Project errors and evaluate results

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained and conclusions the auditor reached (also called 'working papers').

Guidance is given in HKSA 230 (Clarified) *Audit documentation*.

Objectives of audit documentation

- Provides evidence of auditor's basis for conclusion
- Provides evidence that audit was planned and performed in accordance with HKSAs
- Assists engagement team to plan and perform audit
- Assists in direction, supervision and review of audit work
- Enables team to be accountable
- Allows a record of matters of continuing significance to be retained
- Enables conduct of quality control reviews and inspections

Audit documentation must be sufficient to enable an experienced auditor to understand

- nature, extent and timing of procedure
- results
- significant matter/risks

Factors affecting form and content of documentation

- Size and complexity of entity
- Nature of audit procedures
- Identified risks
- Significance of evidence obtained
- Nature and extent of exceptions
- Need to document a conclusion
- Audit methodology and tools used

Audit documentation will be split between **current audit files** and **permanent audit files**.

Current audit files contain information relevant to current year (eg financial statements, review notes, audit plan, management letter).

Permanent audit files contain information of continuing importance (eg engagement letter, legal documents, board minutes, prior years' financial statements).

Notes

10: Fraud and irregularities

Topic List

The extent of auditors' responsibilities in relation to fraud is a critical element of the public's perception of the auditor's role. Guidance is given in HKSA 240 (Clarified).

Fraud is an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.

The directors are responsible for preventing and detecting fraud.

HKSA 240 (Clarified) states that auditors must consider the risks of material misstatements in the financial statements due to fraud and error. The team must discuss FS susceptibility to fraud, and risk assessment procedures to be carried out.

An **error** is an unintentional misstatement.

Exam focus

Look for **factors** in questions which might indicate a **risk** of fraud. These could include:

- Management with poor integrity
- Deficient internal control components
- Unusual transactions
- Financial reporting pressures
- Problems in gaining sufficient appropriate evidence
- Unique issues arising from systems

There are two instances where HKSA 240 (Clarified) states risk of fraud must be presumed:

1. Revenue recognition – the auditor must document reasons for concluding there is no presumption of fraud in revenue recognition
2. Control override

Overall responses to assessed risk of fraud

- Assign appropriate staff
- Increase professional scepticism
- Evaluate accounting policies
- Incorporate unpredictability into audit

Responses at assertion level

- Change **nature** of procedures (eg source of evidence changed to external)
- Change **extent** of procedures (sample sizes)
- Change **timing** of procedures (interim procedures/increased year end)

Responses to risk of controls override

- Test appropriateness of journals
- Review accounting estimates for bias
- Evaluate significant transactions outside normal course of business

Completion issues

- Analytical procedures at end of audit
- Written representations about management's responsibilities
- Communication with management/those charged with governance
- Audit report affected?

The **auditors' responsibilities** for considering laws and regulations as part of their audit are discussed in HKSA 250 (Clarified) *Consideration of laws and regulations in an audit of financial statements.*

- **Procedures**
  Must obtain an understanding of the business so as to identify any examples of non-compliance
- **Evidence**
  Must obtain sufficient appropriate audit evidence of compliance with laws and regulations with a direct effect on material amounts and disclosures in the FS.
- **Document findings**
  Document non-compliance and the results of discussion with management, those charged with governance and third parties.

Reporting non-compliance

Management

- Non-compliance should be discussed with management/those charged with governance

Shareholders

- Consider the impact on audit report – modified opinion

Third parties

- Is there a statutory duty?
- Is it in the public interest?
- Role of confidentiality

Management are responsible for ensuring that laws and regulations are complied with.

Money laundering is a process by which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activities.

Potential offences by Accountants

- handling proceeds of crime
- failure to report knowledge/suspicion
- "tipping off"
- failure to comply with regulatory requirements

Making a disclosure which is likely to prejudice an investigation into money laundering.

Policies and procedures

- Appointment of MLRO
- Customer identification procedures
- Enhanced record keeping
- Communication and training
- Internal controls, risk assessment, management and monitoring

Also known as customer due diligence (CDD) or 'know your client' (KYC) procedure.

Governed in HK by the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) ordinance, which imposes both criminal and supervisory sanctions.

Notes

11: Internal control and tests of controls

Topic List

Internal controls are a key topic area.

Internal control is the process designed, implemented and maintained by those charged with governance, management and other personnel, to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Components of internal control

- Control environment
- Risk assessment process
- The information system relevant to financial reporting
- Control activities
- Monitoring of controls

Relevant controls

Not all controls are relevant to the auditor's risk assessment. The auditor is primarily concerned with those which are part of the management of risk that may give rise to a material misstatement in the FS.

Control environment

The attitudes, awareness and actions of management.

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation by those charged with governance
- Management's philosophy and operating style
- Organisational structure
- Assignment of authority and responsibility
- Human resource policies and practices

Risk assessment process

The process of identifying and responding to business risk.

Does entity:

- Identify risks relevant to financial reporting?
- Estimate their significance?
- Assess likelihood of occurrence?
- Take action?

Information system

This consists of:

- Infrastructure (physical/hardware)
- Software
- People
- Procedures
- Data

An information system relevant to financial reporting **initiates, records, processes** and **reports** transactions.

+

Control activities

Policies and procedures which ensure that management directives are carried out.

- Performance reviews
- Information processing
- Physical controls
- Segregation of duties
- Authorisation

Monitoring of controls

A process to assess the quality of internal control performance over time

- Operating as intended/modified as appropriate
- Internal audit function may perform part of this process

Limitations of internal control

Exam focus

Internal control only provides directors with reasonable assurance that objectives are met because internal control has inherent limitations.

- Costs of a control can outweigh the benefit
- Potential for **human error**
- Possibility of collusion in fraud between employees
- Controls could be bypassed/ overridden by management
- Controls are designed to cope with routine transactions not non-routine ones

- Hence segregation of duties is vital

Auditors must record the client's systems. Narrative notes, flowcharts, questionnaires or checklists may be used.

Narrative notes

- **Advantage:** easy to record
- **Disadvantage:** difficult to update (unless computerised)

Aim to describe and explain the system. Can support flowcharts.

Flowcharts

- **Advantages**: quick to prepare, easy to follow, complete system, eliminate extensive narrative
- **Disadvantages:** only suitable for standard systems, good for document flow not controls, difficult to amend, can waste time

Questionnaires

Two main types:

- Internal control questionnaire (ICQ)
- Internal control evaluation questionnaire (ICEQ)

ICQs Try to answer the question 'how good is the system of controls?'

ICEQs Try to establish if specific frauds/errors are possible.

The advantages of questionnaires are that they are thorough and quick.

Checklists

Similar to internal control questionnaire.

Assessing internal controls

Assessment of systems

Auditors:

- **Assess the adequacy** of the accounting systems as the basis for the FS
- **Identify** the types of **potential misstatement** that could occur in the FS
- Consider **factors** that affect the risk of misstatements
- **Design appropriate audit procedures**

The auditors must gain an understanding of the information system so that they can understand the **major classes of transaction**, **how** transactions are **initiated**, what the **significant records** are, and what the **financial reporting process** is.

Risk assessment procedures

To obtain an understanding of the entity and its environment:

- Inquiries of management and other personnel including internal audit function
- Analytical procedures
- Observation and inspection

ie assessment of controls is an integral part of risk assessment.

Assessment of control risk

Auditors must carry out tests of controls if:

- Risk assessment indicated that controls are operating effectively.
- The auditor has determined it is not possible/practicable to reduce risk at assertion level to acceptable level by substantive procedures.

Tests of controls

Tests of controls are performed to obtain audit evidence about the operating effectiveness of controls in **preventing**, or **detecting** and **correcting** material misstatements.

Tests of controls may include:

- **Inquiries** about and **observation** of control procedures
- **Inspection** of documents supporting controls
- **Examination of evidence of management views**
- **Reperformance** of control procedures to ensure they were correctly performed
- **Testing** on controls operating on specific **computer applications**

If risk assessment has shown controls to be ineffective, testing will not be undertaken. It may also be **inefficient** to test controls if the population consists of a few large items which can be tested quickly by substantive procedures.

When controls testing is completed, auditors make a final assessment of control risk, and **revise** the nature, timing and extent of **substantive procedures** accordingly.

Auditors should consider: **how** controls were applied, **how consistently** they were applied and **by whom**. Controls testing is often completed on an **interim audit**.

Auditors should **combine** inquiry with another type of procedure when testing controls.

In a computerised environment, there are two important types of control.

General controls are controls in place over development (systems design and testing), changes to programs (passwords/records of changes maintained), testing of program changes, prevention of incorrect use (operation controls) and controls to ensure continuity (back-up and disaster recovery).

Application controls relate to procedures used to initiate, record, process and report transactions.

It is important that management have an IT security and use policy which should include the following:

- Procedures including passwords, data protection and information distribution
- Legal requirements (data protection legislation) and licensing agreements
- Commitment to information security
- Overall supervision by senior management
- Consequences of disobeying the rules

HKSA 265 (Clarified) *Communicating deficiencies in internal control to those charged with governance and management* requires communication on various matters including significant deficiencies in control systems. This should be sent on a timely basis after the interim and final audits.

Format of the report to management

DEFICIENCY → IMPLICATION → RECOMMENDATION

Exam focus

The report to management is a popular topic to examine in a scenario question. Your recommendations should be sensible and relevant, and you must always state the implications of the deficiencies identified.

12: Substantive procedures, including analytical procedures

Topic List

In this chapter, we look at substantive procedures, including analytical procedures. These tests are designed to ensure that balances in the financial statements are not materially misstated.

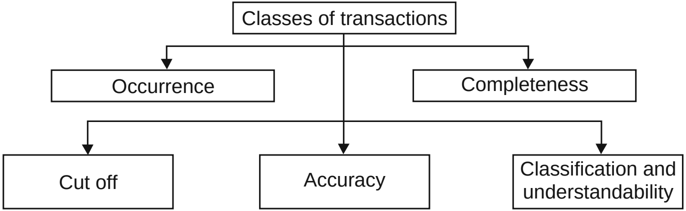
Auditors need to obtain sufficient appropriate audit evidence to support the financial statement assertions. This is done through **substantive testing**.

Substantive procedures are tests to detect material misstatements in the FS.

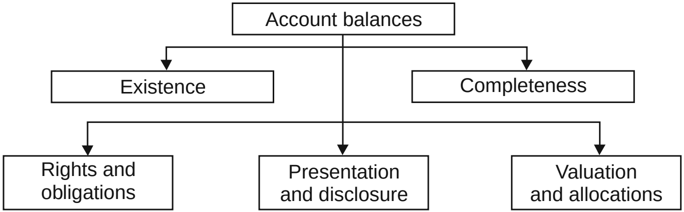
They are generally of two types:

- Analytical procedures
  - Applicable to large volumes of transactions
  - Investigate deviations
  - Consider expected relationships
  - Obtain explanations/corroborate
  - Document
- Tests of details
  - Objective to obtain sufficient appropriate evidence at the assertion level

Substantive testing on statement of profit or loss and other comprehensive income financial assertions



Substantive testing on statement of financial position assertions



<u>HKSA 315 (REVISED) IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENTS THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT</u>

[1. Accounting system 2. Control system 3. Control procedures]
Procedures: Walk-through test, inquiries, review documents, observation, inspection
<u>DEVELOP OVERALL</u> AUDIT PLAN

↓

<u>WALK-THROUGH TESTS</u> TO CONFIRM UNDERSTANDING OF INTERNAL CONTROL

↓

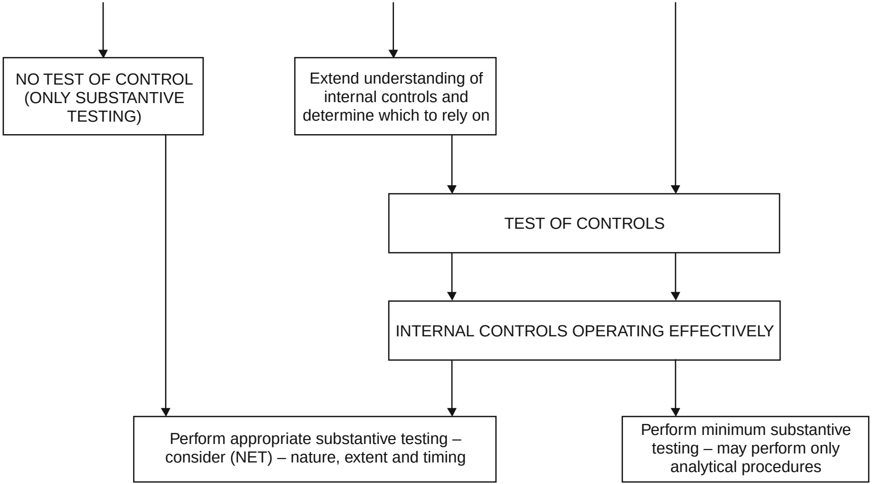
<u>DOCUMENT UNDERSTANDING</u> OF INTERNAL CONTROL SYSTEM

↓

<u>HKSA 315 (REVISED) PRELIMINARY ASSESSMENT</u> OF CONTROL RISK
Assessment of control risk should always be **high** **<u>unless</u>** auditors are <u>able to identify internal controls likely to prevent and correct a material misstatement</u> + **<u>HKSA 330 (CLARIFIED) THE AUDITOR'S RESPONSES TO ASSESSED RISK for planning to perform test of control to support assessment</u>**

↓

HIGH RISK	*MEDIUM RISK*	*LOW RISK*
↓	↓	↓


NO TEST OF CONTROL (ONLY SUBSTANTIVE TESTING)
Extend understanding of internal controls and determine which to rely on
TEST OF CONTROLS
INTERNAL CONTROLS OPERATING EFFECTIVELY
Perform appropriate substantive testing – consider (NET) – nature, extent and timing
Perform minimum substantive testing – may perform only analytical procedures

Analytical procedures are the evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.

HKSA 520 (Clarified) *Analytical procedures* gives guidance on use of analytical procedures as substantive procedures and at the overall review stage of the audit.

Analytical procedures

(a) Comparison of this year's financial information with:
- (i) Similar information for prior periods
- (ii) Anticipated results/budgets
- (iii) Industry information
- (iv) Expectations produced by the auditor

(b) Elements of financial information which are **expected to conform** to patterns

(c) **Links** between financial/non-financial information

(d) Sensitivity analysis

Analytical procedures as substantive tests

- Determine **suitability** for given assertions
- Evaluate **reliability** of data
- Develop an **expectation** and evaluate whether **sufficiently precise**
- Determine amount of **acceptable difference**

Analytical review procedures **MUST** be used as risk assessment procedures and at the overall review stage.

Practical techniques

- Ratio analysis
- Examining related accounts
- Trend analysis
- Reasonableness tests

Significant fluctuations and unexpected relationships

When these are identified, the auditors shall:

- Make inquiries of directors
- Consider management response in light of knowledge/evidence
- Carry out other audit procedures where necessary

Notes

13: Specific audit procedures

Topic List

Key assets

Key liabilities

Other

*This chapter looks at specific audit procedures that an auditor will carry out. You may be asked to list procedures on a specific financial statement area in the exam, so you must know these. You must also be able to explain **why** you are doing them (to confirm completeness, valuation etc) with reference to the financial statement assertions.*

Tangible non-current assets

Key assertions: completeness, existence, valuation, rights and obligations

Completeness

Obtain a summary, reconcile it to last year's schedules. **Reconcile** the list of assets in the **general ledger** with those in the **non-current asset register**. Obtain explanations for missing assets. Trace from assets register to ensure they are recorded.

Existence

Confirm that the company physically inspects all the assets in the register annually. **Inspect assets** (Do they exist? What's their condition? Are they in use?). Reconcile opening and closing motor vehicles by numbers as well as by value.

Valuation

Verify valuation to **valuation certificate** (consider reasonableness of valuation). Recalculate **revaluation surplus**. Check that revaluations are updated regularly. Ensure **disclosure** correct. Review/recalculate depreciation to ensure reasonable/calculated correctly.

Rights and obligations

Verify title to **land** by checking **title deeds/leases**. Obtain certificate from people holding deeds to confirm why they are held. Inspect **registration documents for vehicles**, confirm that they are **used for the business**. Examine documents of title for other assets.

Additions (rights/valuation/completeness)

Check additions to invoices/architect's certificates etc. Check purchases properly allocated to asset accounts and authorised and all additions have been recorded in the general ledger/register.

Disposals (rights/completeness/occurrence)

Verify disposals to **sales documentation** (invoice) and check **calculation of profit/loss** is correct. Check that disposals are **authorised** and proceeds are reasonable. Ensure that asset is no longer used as security.

Intangible non-current assets

Key assertions: EXISTENCE → are they genuinely assets?
VALUATION → at what value should they be recorded?

Goodwill

- Agree consideration to sales agreement
- Asset values reasonable?
- Calculation correct? (Recalculate)
- Any impairment? (Look at impairment review)
- Goodwill valuation reasonable?

Other intangibles

- Agree to purchase documentation (invoice)
- Review any specialist valuations
- Amortisation correct? (Recalculate)

R&D

- Conforms to HKAS 38 criteria?
- Refer to budgets
- Amortisation correct? (Recalculate)

Inventory

Key assertions: Existence, completeness, rights and obligations, valuation, cut-off

Key procedures:

Procedure	Assertion
Attend inventory count and carry out relevant procedures (see next page)	**Existence**, also contributes to completeness and valuation
Ensure no inventory held by third parties (by inquiry) or confirm inventory held by third parties by external confirmation	**Rights and obligations**, also contributes to completeness
Verify costs applied to inventory by carrying out relevant procedures (see page 107)	**Valuation**
Ensure invoices processed in correct period by review	**Cut off**

Planning inventory count

Gain knowledge (previous year) and discuss major changes with management.

Assess key factors (such as, nature of inventories, high value items, accounting, location, controls).

Plan procedures (time/location of attendance, high value items, any specialist help, third party confirmations required?)

Review inventory count instructions

Ensure there is provision for:

Organisation of count (supervision, marking of inventories, control during the process, identification of obsolete inventories).

Counting (systematic counting to ensure all inventories are counted, teams of two counters one independent of inventories usually).

Recording (control over inventory sheets, ink used, signed by counters).

During inventory count

Observe whether **instructions** are followed.

Make **test counts** for accuracy.

Review procedures for **obsolete** inventories.

Confirm **third party** inventories separate.

Conclude whether inventory count has been **properly carried out.**

Gain overall **impression** of inventories.

After inventory count

Trace **test count** items to final inventory sheets.

All count records **included** in final total?

Confirm **cut-off** using final goods in and out records.

Review replies from **third parties.**

Confirm **valuation.**

Remember: inventories should be valued at the lower of cost and net realisable value.

Original cost (All types of inventories)

The auditors must ensure that the **method** used is **allowed** under law and standards, **consistent, calculated correctly**.

Actual costs can be checked by referring to **supplier invoices**.

Production cost (WIP and FG)

Cost is the cost of purchase + **cost of conversion.**

The auditors may be able to use **analytical procedures** to assess the costs of conversion.

Material: check to invoices and price lists.

Labour: check to wage records/time summaries.

Overheads: allocation consistent and based on normal production.

NRV (All types of inventories)

Auditors should compare cost/ NRV. **NRV is likely to be lower** than **cost** where:

- Costs increasing
- Inventories deteriorated
- Inventories obsolete
- Marketing strategy dictates
- Errors made

The auditors should follow up **obsolete items** and **review prices** (by looking at after date sales) and strategies.

Receivables

Key assertions: existence, completeness, valuation

Much of the detailed work will be carried out on a sample of **receivables' balances** chosen from a list of **sales ledger balances**. Ideally, this will be **aged**, showing amounts owed and from when they are owed. The following work should be done:

Completeness

Reconcile balances from sales ledger to list of balances and vice versa

Reconcile the total of the list to the sales ledger control account

Cast the list of balances to ensure it is correct

Confirm whether the list reconciles to the sales ledger control account

Circularisation

Verification of trade receivables by direct circularisation is the normal method of getting audit evidence to check the **existence** and **rights and obligations** of trade receivables. HKSA 505 (Clarified) *External confirmations* provides guidance.

Positive circularisation: customer is requested to confirm the accuracy of the balance shown or state in what respect he is in disagreement (preferable method).

Negative circularisation: customer is requested only to reply if the amount is disputed.

Auditors must maintain control over the preparation and dispatch of confirmation letters.

Sample selection

Special attention to:

- **Old** unpaid accounts
- Accounts **written-off** in period
- Accounts with **credit** balances
- Accounts settled by **round sum payments**

Do not overlook:

- **Nil balances**
- Accounts paid by the time of the audit

Follow up, where:

- Customers disagree with the balance
- Customers do not respond (positive method only)

Reasons for disagreements: disputes, cut off problems, receipt sent before year end but received afterwards, mis-posting, customers netting off credits and debits, teeming and lading frauds. The **auditors should investigate** the reasons for disagreement.

Alternative procedures (where no response arrives):

Second (and third) requests should be sent to the customer in the first instance. Then the auditors should involve the credit controller to chase the debt, and do other tests.

Auditor may check the receipt of cash after date, verify purchase orders, and test the company's control over irrecoverable receivables (see below).

Irrecoverable receivables

A test of the valuation of trade receivables in the statement of financial position. A significant test is reviewing all the **cash received after the year-end date** (which gives evidence on the **collectability** of debts).

Valuation

Procedures

Confirm adequacy of allowance impairment by **reviewing customer** correspondence/ discussion with the credit controller.

Examine customer files for overdue debts and consider whether allowance impairment is sufficient.

Review correspondence with **lawyers** in case legal action is being taken to enforce debts.

Examine **credit notes** issued after the year-end and ensure those relating to invoices in the relevant period have been allowed for.

Investigate all **unusual items** in the sales ledger, for example, credit balances.

Banks and cash balances

Key assertions: completeness, existence, rights and obligations, and allocation/valuation.

All these elements can be audited through the **bank letter**. This is a standard document.

Banks will require:

- Explicit written authority from client
- Auditors' request must refer to it

Guidance is provided by HKSA 505 (Clarified) *External confirmations.* In Hong Kong this guidance should also be applied to confirmations requested of other financial institutions eg. deposit-taking companies.

Bank procedures

- Obtain bank confirmations
- Check the maths of the bank reconciliation
- Trace cheques shown as outstanding to the after date bank statements
- Trace receipts shown as outstanding to after date bank statements
- Review previous bank reconciliation to ensure all amounts are cleared
- Obtain explanations for items in bank statements, not cash book and vice versa
- Verify balances on reconciliation to bank letter and cash book
- Scrutinise the cash book for unusual items

If cash balances at the client are material, the auditor may decide to attend a cash count.

Trade payables and accruals

Auditors should be aware of the possibility of understatement of payables.

There are **two detailed objectives** with regard to trade accounts payable:

- Is cut-off correct between goods received and invoices received?
- Do trade accounts payable represent the *bona fide* amounts due by the company?

Trade accounts payable listing

- Check that the listing has been extracted correctly from the purchase ledger.
- Reconcile the total with the purchase ledger control account.
- Recast the list of balances.

Completeness, rights and obligations, existence

The key test is a comparison of supplier statements with the purchase ledger balances. Supplier statements are third party evidence.

However, it is sometimes necessary to **circularise suppliers**. Examples of such situations are:

- Supplier statements are unavailable/incomplete.
- Internal controls are weak and material misstatement of liabilities is feared as a consequence.
- Suspicion that client is understating deliberately.

As a general rule, accruals lend themselves to being audited by analytical procedures as they should be comparable to prior years. Other substantive procedures are noted here.

General accruals

(completeness and valuation)

Recalculate accruals and trace back to supporting documentation.

Review ledger accounts to ensure all accruals have been included.

Scrutinise post year-end payments to see if any should have been accrued.

Consider basis for round sum accruals (comparable to last year?).

Tax accruals

(completeness and valuation)

Profits tax: Likely to be EBIT times standard tax rate. Check amount paid to the tax authority.

Property tax: Check reasonableness to last payment. Verify amount paid in year to cashbook.

Non-current liabilities

Non-current liabilities are those due after more than one year. Usually they are debentures, loan stock and bank loans.

The key financial statement assertions are:

- **Completeness:** whether all long-term liabilities have been disclosed
- **Accuracy:** whether interest payable has been calculated correctly and included in the right period
- **Classification/understandability:** whether long-term loans are correctly disclosed

Audit procedures

- Obtain/prepare a schedule of loans.
- Agree opening balances to prior year and recast.
- Compare the balances to the general ledger.
- Check lenders to any register of lenders (eg debenture holders).
- Trace additions and repayments to cash book.
- Confirm repayment conforms to agreement.
- Verify borrowing limits per the articles are not exceeded.
- Obtain direct confirmation from lenders.
- Review minutes and cash book to ensure that all loans have been included.

Provisions and contingencies

A **contingent liability** is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence/non-occurrence of one or more events not within the entity's control, or a present obligation arising from past events that is not recognised because it is not probable that an outflow of resources will be required or the amount cannot be measured reliably. A **contingent asset** is a possible asset that arises from past events to be confirmed by future events not wholly within the entity's control.

A **provision** is a liability of uncertain timing or amount, to be settled by the transfer of economic benefits.

A provision should be recognised as a liability when:

- An entity has a present obligation (legal or constructive) from a past event
- It is probable that an outflow of resources embodying economic benefits will be required to settle it
- A reliable estimate can be made of the obligation

Audit procedures

The auditor considers whether management has recognised any **impairment loss** for litigation and claims.

- Reviewing correspondence
- Discussion with the directors
- Referring to comparable past events
- Seeking verification from lawyers
- Recalculating provisions for accuracy
- Considering the nature of the business

Share (equity) capital

Auditors should ensure that the directors have observed their legal duties in regard to share capital and reserves (for example, not distributed undistributable reserves).

- Agree authorised share capital to the memorandum.
- Verify share transfer details and cash payments to cash book.
- Agree dividends paid to cash book and to the minutes of the AGM where the dividend was proposed.
- Check calculation of movement on reserves.

Segment information

- Not required to perform procedures to enable to give audit opinion on segment information on stand alone basis

- When segment information is **material** to FS obtain sufficient appropriate evidence about disclosures by:
  - Analytical procedures
  - Obtaining understanding of entity's methods
  - Tests over process

Sales

Internal controls are likely to be tested.

Completeness and occurrence

Analytical procedures are likely to be important.

Consider:

- Level of sales, year on year
- Effect of changing quantities sold
- Effect of changing prices
- Levels of goods returned/ discounts
- Efficiency of labour/sales

Accuracy

Check:

- Pricing/additions on invoices
- Discounts properly calculated
- Sales tax added correctly
- Casts in sales ledger
- Control account reconciliation

Also, trace debits in sales ledger to credit notes

Sales cut-off

Goods in inventory are not also treated as sales in the year.

Check goods dispatched and returns inward around the year end to ensure:

- Invoices/credit notes dated in the same period
- Invoices/credit notes posted to the sales ledger in the same period

Review the sales ledger control account for unusual items near the year end and review material after-date invoices and credit notes to see if in correct period

- Special sales
  - Comply with HKAS 18?
  - Analytical procedures
  - Recalculation
- Consignment sales → **Risks**
  - Internal controls
  - External confirmation

Risks

- Completeness (if consignees do not provide fast/accurate information)
- Occurrence (if not properly distinguished from other sales)
- Accuracy (if accounted for wrongly)

Purchases

Internal controls are likely to be tested.

Occurrence/completeness

Analytical procedures are important. Consider:

- Level of purchases/expenses month by month
- Effect of quantities purchased
- Effect of changing prices
- Ratio of purchases to trade payables
- Ratio of trade payables to inventory

Additional tests include tracing purchases and other expenses from the nominal ledger to the purchase ledger and invoices. Are they valid for the company/authorised?

Cut-off (completeness)

Check from the **last goods received note** (from inventory count) to the ledger or list of accruals.

Review the **schedule of accruals** to check that goods received after the year-end are not included.

Review invoices and credit notes after the year-end to ensure that those relating to prior year are included.

Reconcile batch postings around the year-end, to ensure that invoices are posted in the correct period.

Payroll

Internal controls are likely to be tested.

Wages and salaries

The key financial statement assertions are completeness and valuation

Analytical procedures will give some assurance on pay liabilities. However, auditors may also carry out tests such as: checking remuneration per payroll to personnel records, confirming existence of employees by meeting them, checking calculations on the payroll, checking validity of deductions to supporting documentation, confirming net pay to bank.

Financial instruments

HKAPG 1000 provides:

- background information about financial instruments
- discussion of the audit considerations

Controls

- need an appropriate control environment
- need a risk management process
- suitable information system required
- appropriate accounting policies including reduction

Audit considerations

- perceived to be difficult to understand
- liquidity can change; volatile markets
- related payments highly material; risk of misappropriation of assets
- evidence of valuation may be difficult to obtain
- significant risk and exposures

14: Using the work of others

Topic List

When using the work of third parties, the auditor should consider the scope, function and reports involved. Link this chapter with your evidence chapters - when would you use external help?

An **auditor's expert** is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence.

HKSA 620 (Clarified) *Using the work of an auditor's expert* requires the auditor to agree the following with the expert.

1. Nature, scope and objectives of their work
2. Respective roles and responsibilities
3. Nature, timing and extent of communication, including form of any report
4. Confidentiality requirements

Audit procedures

- Assess competence
- Obtain understanding of field of expertise
- Assess capabilities
- Consider objectivity

Evaluating adequancy of work

The auditor must assess the relevance and reasonableness of

- auditor's experts findings or conclusions
- significant assumptions and methods
- accuracy of source data

- nature of matter to which expert's work relates
- risk of material misstatement
- significance of expert's work on audit

A **service organisation** is an organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting. A **user entity** is the entity which purchases those services and whose financial statements are being audited.

Planning

- Know what is outsourced
- Understand the contract
- Risk of misstatement

Designing procedures (depends on):

- Contract nature
- Degree of authority delegated
- Quality assurance
- Nature of assets involved
- Reputation of service provider

Auditor considerations

- Are the terms of the contract with the service organisation sufficiently clear to ensure that a good service will be provided?
- How are the relevant accounting records maintained?
- Does the user entity have the right to inspect the service organisation's records?
- What is the degree of interaction between the service organisation and the user entity?
- Does the user entity monitor the performance?
- Does the service organisation indemnify the user?
- Can the auditors have access to relevant records?

Procedures

- Inspecting records and documents held by the user entity
- Establishing the effectiveness of internal control
- Obtaining representations to confirm balance and transactions from the service organisation
- Performing analytical procedures on
  - The records maintained by the user entity, or
  - The returns received from the service organisation
- Requesting specified procedures performed by
  - The service organisation
  - The user entity's internal audit department
- Reviewing information from the service organisation or its auditors concerning the design and operation of its control systems
- Obtaining a Type 1 or Type 2 report under HKSA 402 (Clarified)

Using reports

If the auditor makes use of the service organisation's report, he should consider the reputation/skill of the service provider, and what the report is about. He must not refer to the report in his audit report.

15: Accounting estimates, opening balances and comparatives

Topic List

Risk increases with estimates and judgements so look out for estimates in the exam.

An accounting estimate is an approximation of a monetary amount in the absence of a precise means of measurement.

Examples

- Impairment of receivables
- Inventory obsolescence
- Warranty provisions
- Depreciation method/useful life
- Outcome of long-term contracts
- Contingent liabilities
- Investment impairment
- Complex financial instruments (not on an active market)
- Share based payments
- Property held for disposal
- Deferred tax

Estimation uncertainty refers to the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in measurement.

Examples: high estimation uncertainty

- Outcome of litigation
- Fair value estimates for
  - Derivative financial instruments not publicly traded
  - Specialised entity-developed model

Auditors' risk assessment procedures

- Understand financial reporting framework
- Understand management's process:
  - Identification of need
  - Method/calculation
  - Controls over process
- Understand assumptions used
- Understand reasons when changes made to methods
- Review prior periods

Auditors' responses

- Review events since year end
- Test management calculations
- Test controls over process
- Develop **point estimate**
- Check disclosures
- Consider possibility of management bias
- Make final assessment of reasonableness

Additional procedures are required in response to **significant risks.**

Auditors' **point estimate** is the amount or range of amounts derived from audit evidence for use in evaluating management's point estimate.

Opening balances are those account balances that exist at the beginning of the period, reflecting the effect of transactions of the preceding period and its accounting policies.

Auditors must obtain sufficient appropriate audit evidence that:

- Opening balances are correctly brought forward
- They do not contain misstatements material to current year figures
- Accounting policies are consistently applied or changes adequately disclosed

Incoming auditors

Testing opening balances can be difficult for new auditors because they did not audit the prior year figures. They should:

- Ascertain whether prior report was unqualified
- Undertake discussions with management about opening figures
- Undertake substantive procedures on opening figures if concerns arise

Comparative information is the amounts and disclosures included in the financial statements in respect of one or more prior periods. It includes corresponding figures and comparative financial statements.

Continuing auditors

- Check balances b/f correctly
- If unresolved prior year problem is material to CY, qualify report due to opening balances and comparatives
- If material to CY but opening balances are not affected, report should refer to comparatives
  - Modification
  - Emphasis of matter paragraph

Incoming auditors: audited comparatives

- Responsible for comparatives as part of CY accounts
- Procedures as for continuing auditors

Incoming auditors: unaudited comparatives

- Ensure there is clear disclosure that the comparatives are unaudited
- Should carry out procedures as for continuing auditors, as far as possible

Reporting

- for **corresponding figures** the auditor's report only refers to FS of the current period
- for **comparative financial statements** the auditor's report refers to each period that FS are presented

16: Overall audit review and finalisation

Topic List

- Subsequent events
- Going concern
- Written representations
- Related parties
- Overall review
- Other information
- Communication
- Misstatements

The review stage of the audit is very important and highly likely to come up in the exam.

Subsequent events are events which occur between the date of the FS and the date of the auditors' report, and facts that become known to the auditor after the date of the report. There are two types of event:

- Provide further evidence of conditions that existed at the period-end **(adjusting events)**.
- Indicative of conditions which arose subsequent to the period-end **(non-adjusting events)**.

Prior to audit report being signed

Auditors shall perform procedures designed to obtain sufficient appropriate audit evidence that subsequent events requiring adjustment or disclosure in the financial statements have been identified. These are likely to include:

Audit procedures

- Inquiries of management

  (Status of judgemental issues, new commitments, unusual accounting adjustments etc)
- Reading minutes of meetings
- Reviewing most recent financial information

After the audit report has been signed

Before FS issued

Auditors do not have any obligation to perform procedures or make enquiries regarding the financial statements after the date of their report.

If material subsequent events become known, the auditor shall:

(a) Discuss the matter with management and where appropriate, those charged with governance

(b) Determine whether the financial statements need amendment and, if so,

(c) Inquire how management intends to address the matter in the financial statements

If appropriate, the auditors should extend their procedures and issue a new audit report.

After FS issued

Auditors have no obligation to perform procedures or make enquiries regarding the financial statements after they have been issued.

When management revise the financial statements the auditor shall:

(a) Carry out necessary audit procedures

(b) Review steps taken by management to ensure anyone in receipt of the previously issued financial statements is informed

(c) Extend the audit procedures to the date of the new auditor's report

(d) Issue a new report on the revised financial statements

The amended auditor's report should contain an emphasis of matter or other matters paragraph.

Going concern assumption

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

Auditor responsibilities

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements, to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern and to consider the implications for the audit report.

Risk assessment

When performing risk assessment procedures, the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern (examples given below). If management has performed a preliminary assessment of the entity's ability to continue as a going concern, the auditor shall discuss it with management. The auditor shall remain alert throughout the audit for any factors which would indicate problems.

Examples

Financial

- Net liabilities
- Fixed term borrowing approaching maturity without realistic prospect of renewal/repayment
- Negative operating cash flows
- Adverse financial ratios
- Substantial operating losses
- Inability to finance new products

Operating

- Loss of key management/markets/franchise
- Labour difficulties/supply shortage
- Emergence of highly successful competitor

Other

- Major legal proceedings/non-compliance

Evaluation

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

Additional audit procedures

When events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures. Examples include:

- Analysis and discussion of cashflow/profit/other forecasts/interim FS with management
- Read minutes of shareholder meetings
- Make enquiries of lawyers regarding legal claims
- Reading terms of debentures/loan agreements

Reporting

Adequate disclosure

↓

Emphasis of matter paragraph

Without qualifying our opinion we draw attention to Note X in the financial statements which indicates that the company incurred a net loss of ZZZ during the year ended 31 December 20X1 and, as of that date, the company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the company's ability to continue as a going concern.

Inadequate disclosure

↓

Qualified/adverse opinion

Inappropriate use of GC assumption

↓

Adverse opinion

If there are multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate (in extremely rare cases) to express a **disclaimer of opinion**.

The auditor requests written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

General representations

- Management fulfilled responsibility for preparation and presentation of FS
- FS prepared and presented in accordance with applicable FR framework
- All relevant information provided
- All transactions recorded and reflected
- Description of management's responsibilities

Specific representations

- Due to provisions of other HKSAs
- To support audit evidence

If management do not provide written representations, the auditor must disclaim an opinion on the financial statements.

Related party

A related party is either as defined in HKAS 24, or:

(a) A person or other entity that has control or significant influence, directly or indirectly, through one or more intermediaries, over the reporting entity.

(b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries.

(c) Another entity that is under common control with the reporting entity through having either common controlling ownership, owners who are close family members or common key management.

Auditors shall inquire of management regarding:

(a) The identity of the entity's related parties.

(b) The nature of the related party relationships.

(c) Any transactions with the related parties during the period, and if so, their type and purpose.

(d) Controls to identify, account for and disclose related party relationships and transactions.

(e) Controls over authorisation and approval of significant related party transactions and transactions outside the normal course of business.

Issues

- Inherent difficulties of (self) detection
  - Not even necessarily evident to management
  - Transactions not necessarily charged for (not processed)
  - Chance of concealment by management
  - Complex corporate structures
- Responsibility of management to identify related parties
- Materiality – judged in relation to related parties not entity
- Professional scepticism important
- Controls over unusual transactions

Evidence

There are two key problems with regard to evidence:

- May be limited
- May be created by the related party

Sources of evidence

- Minutes of meetings of those charged with governance
- Analytical review of transactions
- Confirmation of loans (eg who is guarantor)
- Written representations
- Correspondence with lawyers
- Inquiry

Towards the end of their audit, the auditors should review the financial statements to ensure that they are reasonable, and consistent with evidence obtained, so that they can draw a conclusion on truth and fairness.

They must undertake analytical procedures as part of this.

Review for consistency and reasonableness

1. Do FS adequately reflect **explanations** received?
2. Are there any **new factors** in presentation?
3. Do **analytical procedures** produce expected results?
4. Has the **presentation** been unduly affected by directors' wishes?
5. What is the potential impact of **uncorrected misstatements**?

Compliance with accounting regulations

The auditors should **examine the accounting policies**, considering: what policies are usually adopted in the industry, whether there is substantial authoritative support for the policy, whether departures are necessary for a true and fair view, whether the FS reflect the substance of the underlying transactions.

Some accounting standards allow a **choice of methods**, which often have a material effect.

Other information

Financial and non-financial information other than the financial statements and the auditor's report, which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon.

Examples

- Financial summaries/highlights
- Employment data
- Report by management/directors on operations
- Planned capital expenditures
- Financial ratios
- Names of officers/directors
- Selected quarterly data

Auditors should always ensure that the other information does not contain:

- A misstatement of fact
- An inconsistency with the audited financial statements

On discovering a material inconsistency, the auditor must determine whether the audited financial statements or other information needs to be revised.

If a material misstatement of fact is discovered in the other information, the auditor must discuss this with management.

Where a misstatement of fact or inconsistency is found in the other information and is not corrected, the auditor will include an 'other matter' paragraph in the audit report.

Reporting to those charged with governance

Guidance on reporting to management and other non-shareholders as a by-product of audit is given in HKSA 260 (Clarified) *Communication with those charged with governance.*

Those charged with **governance** is the term used to describe the role of persons or organisations with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

Matters should be discussed with those charged with governance on a **sufficiently prompt basis** so that they can react to what the auditor has said. The auditor should determine who those charged with governance are.

If an **audit committee** exists, it is likely to be the appropriate body to report matters arising from the audit to. Such relevant matters are outlined below.

Matters to communicate

- The auditor's responsibilities in relation to the financial statement audit
- Planned scope and timing of the audit
- Significant findings from the audit
- Auditor independence (listed entities)

Treatment of errors

A **misstatement** is a difference between the amount, classification, presentation or disclosure of a reported financial statement item and the amount, classification, presentation or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatement can arise from error or fraud

An **uncorrected misstatement** is a misstatement accumulated by the auditor during the audit which has not been corrected.

HKSA 450 (Clarified) *Evaluation of misstatements identified during the audit* provides guidance.

Types of misstatements

- Factual (no doubt)
- Judgemental (management's judgement concerning accounting estimates or accounting policies)
- Projected (auditor's best estimate)

HKSA 450 (Clarified)

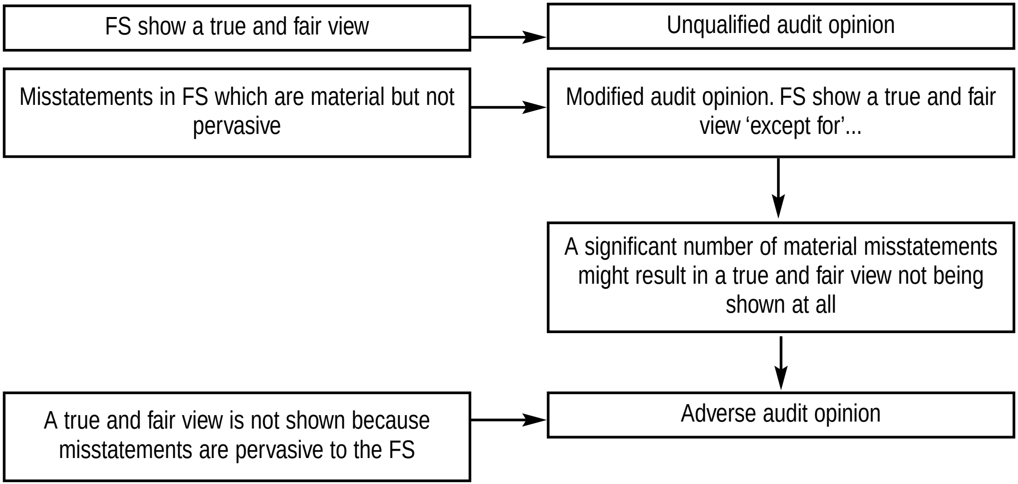
The auditor must communicate all misstatements accumulated during the audit to the appropriate level of management on a timely basis and request them to be corrected (except those which are clearly trivial).

The auditor must obtain a written representation that management believes the effects of uncorrected misstatements are immaterial to the financial statements as a whole.

17: Audit reporting

Topic List

The audit report is the final product of the audit process. You may be required to describe different types of modification in a knowledge or scenario question.


FS show a true and fair view
Unqualified audit opinion
Misstatements in FS which are material but not pervasive
Modified audit opinion. FS show a true and fair view 'except for'...
A significant number of material misstatements might result in a true and fair view not being shown at all
A true and fair view is not shown because misstatements are pervasive to the FS
Adverse audit opinion

The auditor cannot tell whether a true and fair view is given in respect of material item(s) due to an inability to obtain sufficient appropriate audit evidence → Modified audit opinion. Accounts show a true and fair view 'except for'... + any implied opinions

Auditor cannot tell whether a true and fair view is given at all due to inability to obtain sufficient appropriate audit evidence → Disclaimer of opinion + any implied opinion

Question 1

Have all the procedures necessary to meet auditing standards and to obtain all the information and explanations necessary for the audit been carried out?

Question 2

Have the financial statements been prepared in accordance with the applicable accounting requirements?

Question 3

Do the financial statements give a true and fair view?

Basic elements of auditor's report

- Title
- Addressee
- Introductory paragraph
- Directors' responsibility for the financial statements
- Auditor's responsibility
- Basis of opinion
- Auditor's opinion
- Other reporting responsibilities (if applicable)
- Date of the auditor's report
- Auditor's address
- Auditor's signature

In an **unmodified** auditor's report, the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In our opinion, the financial statements *give a true and fair view of* the company's affairs as of 31 December 20X1, and *of* its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards, and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Modifications to the independent auditor's report

HKSA 705 (Clarified) *Modifications to the opinion in the independent auditor's report* deals with situations where the auditor cannot issue an unmodified opinion.

There are two circumstances under which the auditor's opinion will be modified.

1. The auditor concludes that the financial statements as a whole are **not free from material misstatement** (qualified opinion or adverse opinion).
2. The auditor is **unable to obtain sufficient appropriate audit evidence** to conclude that the financial statements as a whole are free from material misstatement (qualified opinion or disclaimer of opinion).

Exam focus

For a matter to affect the auditor's opinion it must be **material** or **pervasive** to the financial statements.

Emphasis of matter paragraphs and other matter paragraphs

An **emphasis of matter paragraph** is included in the auditor's report to refer to a matter already appropriately presented or disclosed in the financial statements which is of such importance that it is fundamental to users' understanding of the financial statements.

Emphasis of matter paragraphs – examples

- Uncertainty relating to future outcome of exceptional litigation or regulatory action
- Early application of a new accounting standard that has a pervasive effect
- Major catastrophe that has a significant effect on financial position

An **other matter paragraph** is included in the auditor's report to refer to a matter other than those presented or disclosed which is relevant to users' understanding, or the auditor's responsibilities.

HKSA 706 (Clarified) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report* provides guidance.

18: Group audits

Topic List

There are special considerations for group audits at all stages. You should consider particularly acceptance and communication with component auditors.

Understanding the component auditors

Group engagement team must obtain an understanding of:

- Whether the component auditor understands the relevant ethical requirements and is independent
- The component auditor's professional competence
- Whether the group engagement team will have sufficient involvement in the work of the component auditor
- Whether the component auditor operates in a regulatory environment that actively oversees auditors

Communication with the component auditors

Engagement team will communicate:

- Work to be performed and the use to be made of it
- A request to confirm that component auditor will co-operate with the group engagement team
- Relevant ethical requirements
- Component materiality
- Identified significant risks
- Related parties

Component auditor will communicate:

- Identification of information reported on
- Risks of material misstatements in group financial statements
- Lists of uncorrected misstatements
- Indicators of management bias
- Material deficiencies in internal control over financial reporting
- Other significant matters including fraud/suspected fraud

The group engagement partner shall **assess risks** and determine the type of work to be performed on the financial information of components.

Group engagement team must be involved in risk assessment

Significant components

Work to be done by group engagement team or component auditor on their behalf

Individual financial significance

(Full) Audit of financial information

Significant due to risks of material misstatements due to specific circumstances

One of:

- (full) audit of financial information using component materiality
- audit of one or more account balances or classes of transaction relating to the likely risks
- specified audit procedures relating to the likely risks

Components that are not significant

Group engagement team shall perform analytical procedures at group level.

Evaluation of component auditors work

- Evaluate communications from component auditor
- Discuss matters arising with component auditor or component management
- Decide whether it is necessary to review parts of component auditor's audit documentation
- **If** conclusion is that component auditor's work is insufficient, determine additional procedures required

New HK Companies Ordinance

- Enhanced right of auditors to require information and explanations from a wider range of persons
- Including non-HK incorporated subsidiaries
- Criminal sanctions against those not supplying information

19: Audit-related services and other assurance engagements

Topic List

In recent years, management of companies has been asked to provide more information. As a result, auditors have been asked to report on more information, extending the use of assurance engagements.

A **review engagement** enables an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared in accordance with the reporting framework.

Examples

Attestation engagement: where accountant declares whether given premise is correct or not.

Direct reporting engagement: where accountant reports on matters arising in the course of the review.

Reviews follow a similar process to auditing

- Planning
- Seeking evidence (often analytical procedures are used)
- Reporting conclusions

Negative assurance is given on review assignments.

Negative assurance is assurance of something in the absence of any evidence arising to the contrary.

Form of unqualified review report (HKSRE 2410 *Review of interim financial information performed by the independent auditor of the entity)*

Review report to....

Introduction

We have reviewed the interim financial information set out on pages 10 to 20 which comprise ... . The directors are responsible for the preparation and presentation of this interim financial information in accordance with Hong Kong Financial Reporting Standards. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of review

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410 ... A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with HKSA and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the interim financial information is not prepared in all material respects, in accordance with Hong Kong Financial Reporting Standards.

Date *AUDITOR*

Address

Agreed-upon procedures are where an auditor is engaged to carry out procedures of an audit nature which have been pre-agreed, and to report **factual findings**. Results are confined to those parties who have commissioned the report and the recipients must form their own conclusions. (HKSRS 4400)

Operational audits are audits of the operational processes of the organisation. They are also known as management, or efficiency audits. Their prime objective is monitoring of management's performance, ensuring company policy is adhered to. These are often carried out by internal auditors.

An accountant may be engaged to use their accounting expertise, as opposed to auditing expertise, to collect, classify and collate information, eg tax return or accounts. This is known as a **compilation engagement.** No assurance will be expressed on the financial information.

HKSRS 4410 (Revised) clarifies the accountant's role and responsibilities. It emphasises the importance of quality control, and provides detailed guidance on the Practitioner's Report.

Assurance engagements other than audit or review of historic financial information

HKSAE 3000 gives guidance. Consider:

- Ethical requirements
- Quality control procedures
- Acceptance appropriate?

'**Value for money**' is a performance measure summarised in three qualities (which a product or activity possesses):

- **Economy**
- **Efficiency**
- **Effectiveness**

Management should, as part of normal business process, assess economy, efficiency and effectiveness in operations (a value for money audit).

Compliance audits are audit checks intended to determine whether employee actions are in accordance with policy/law/regulations. They are normally performed by internal audit.

Value for money audit is an assignment which internal audit can undertake on behalf of management in its **monitoring** role.

It can be carried out on any area of the business at the request of management (eg, service delivery, management process, environment).

Economy: attaining the appropriate quantity and quality of physical, human and financial resources (inputs) at the lowest cost.

Efficiency: this is a measure of the relationship between goods and services produced (outputs) and the resources used to produce them (inputs).

Effectiveness: how well an activity is achieving its policy objectives or other intended effects.

Reporting on the compilation of pro forma financial information included in a prospectus (HKSAE 3420)

- Assess suitability of applicable criteria
- Consider materiality
- Understand how pro forma infomation has been complied
- Obtained evidence of source of unadjusted financial information
- Obtain evidence about calculations
- Evaluate presentation

Express opinion

– reasonable assurance

Reporting on summary financial statements (HKSA 810)

- Only accept engagement if auditor of full financial statements

Express opinion

1. The summary financial statements are consistent in all material respects with the audited financial statements.....or
2. The summary financial statements are a fair summary of the audited financial statements.

Other examples of engagements auditors might perform

- Assurance reports on greenhouse gas statements (HKSAE 3410)
- Preliminary announcement of annual results (PN 730)
- Comfort letters (HKSIR 400)
- Due diligence on financial and non-financial information (HKSIR 400)
- Assurance reports on control at a service organisation (HKSAE 3402)
- Audit of financial statements prepared in accordance with SME-FRS (PN 900)

Notes

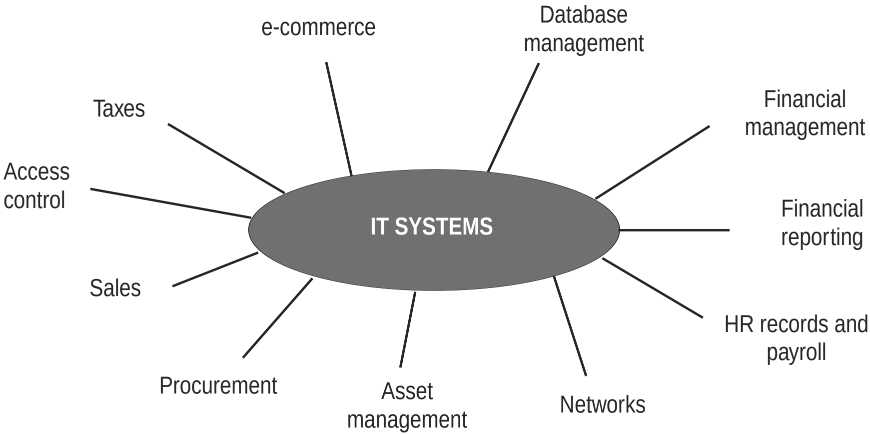
20: Information technology

Topic List

- Information technology audits
- IT environment
- CAATs

Businesses now use information technology in many ways. It is important that auditors understand common IT applications. Computer Assisted Auditing Techniques (CAATs) are an important audit tool.

The diagram below shows the various areas of IT in the entity which might be subject to a test of controls by the auditors.



Audits can be carried out either **around** the computer or **through** the computer:

- **Auditing around the computer** tests inputs and outputs. Only appropriate when there is a clear audit trail within the system, the system is simple and up to date documentation exists.
- **Auditing through the computer** test the controls within the system itself. This is the approach customarily adopted by auditors and often involves CAATs.

Implementation of new IT system

System development process

Project definition

↓

Feasibility study

↓

Design

↓

Programming or software selection → Bespoke or off the shelf

↓

Installation

↓

Post-implementation

System conversion approach

- Pilot system
- Phased operation
- Parallel operation

Increased risk of fraud and error during the transition period must be considered.

It is now common for both businesses and auditors to use **computers**.

Computer assisted audit techniques (CAATs) are audit procedures performed using computers which can enhance the detail of the test undertaken and the result of the test. They consist of **audit software** and **test data**.

Audit software

This performs checks that auditors would otherwise have had to do by hand.

- **Interrogation** (data files)
- **Comparison** (comparing versions)
- **Interactive** (on-line)
- **Resident code** (as transactions are processed)

Test data

This is a way of **checking whether systems are operating properly:** feed the system some data to see how it is processed.

The data may be valid or invalid, depending on the objective of the test.

Notes