

Qualification Programme

Module C: Business Assurance



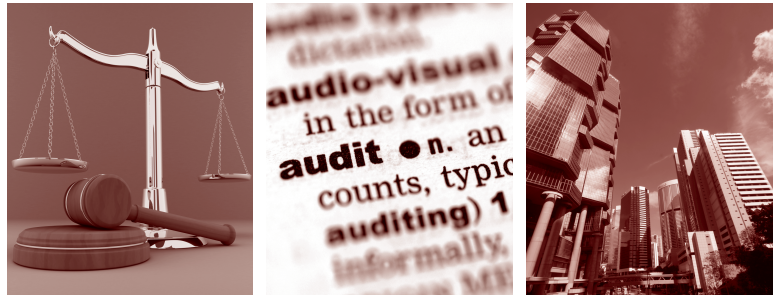
FOURTH EDITION



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



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



Qualification Programme

Module C

Business Assurance



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



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Director's message

Welcome to the Qualification Programme (QP) of the Hong Kong Institute of Certified Public Accountants (HKICPA).

You have made the decision to complete the HKICPA's QP which entails completing the training programme, passing professional examinations and acquiring practical experience under an authorized employer or supervisor. This marks a further step on your pathway to a successful business career as a CPA and becoming a valued member of the HKICPA.

The QP comprising four core modules and a final examination will provide you with a foundation for life-long learning and assist you in developing your technical, intellectual, interpersonal and communication skills. You will find this programme challenging with great satisfaction that will open a wide variety of career opportunities bringing in attractive financial rewards.

A module of the QP involves approximately 120 hours of self-study over fourteen weeks, participation in two full-day workshops and a three-hour open-book module examination at the module end. We encourage you to read this Learning Pack which is a valuable resource to guide you through the QP.

The four core modules of the QP are as follows:

- Module A: Financial Reporting
- Module B: Corporate Financing
- Module C: Business Assurance
- Module D: Taxation

Should you require any assistance at any time, please feel free to contact us on (852) 2287 7228.

May I wish you every success in your QP!

Jonathan Ng
Executive Director
Hong Kong Institute of Certified Public Accountants

Introduction

This is the fourth edition of the Learning Pack for Module C Business Assurance of the HKICPA Qualification Programme.

The Institute is committed to updating the content of the Learning Pack on an annual basis to keep abreast of the latest developments. This edition has been developed after having consulted and taken on board the feedback received from different users of the previous edition. Some of the examples and self-test questions have been rewritten to better reflect current working practices in industry and facilitate the learning process for users of the Learning Pack.

The Learning Pack has been written specifically to provide a complete and comprehensive coverage of the learning outcomes devised by HKICPA, and has been reviewed and approved by the HKICPA Qualification and Examinations Board for use by those studying for the qualification.

The HKICPA Qualification Programme comprises two elements: the examinations and the workshops. The Learning Pack has been structured so that the order of the topics in which you study is the order in which you will encounter them in the workshops. There is a very close inter-relationship between the module structure, the Learning Pack and the workshops. It is important that you have studied the chapters of the Learning Pack relevant to the workshops before you attend the workshops, so that you can derive the maximum benefit from them.

On page (ix) you will see the HKICPA learning outcomes. Each learning outcome is mapped to the chapter in the Learning Pack in which the topic is covered. You will find that your diligent study of the Learning Pack chapters and your active participation in the workshops will prepare you to tackle the examination with confidence.

One of the key elements in examination success is practice. It is important that not only you fully understand the topics by reading carefully the information contained in the chapters of the Learning Pack, but it is also vital that you take the necessary steps to practise the techniques and apply the principles that you have learned.

In order to do this, you should:

- work through all the examples provided within the chapters and review the solutions, ensuring that you understand them;
- complete the self-test questions within each chapter, and then compare your answer with the solution provided at the end of the chapter; and
- attempt the exam practice questions that you will find at the end of the chapter. Many of these are HKICPA past examination questions, which will give an ideal indication of the standard and type of question that you are likely to encounter in the examination itself. You will find the solutions to exam practice questions at the end of the book.

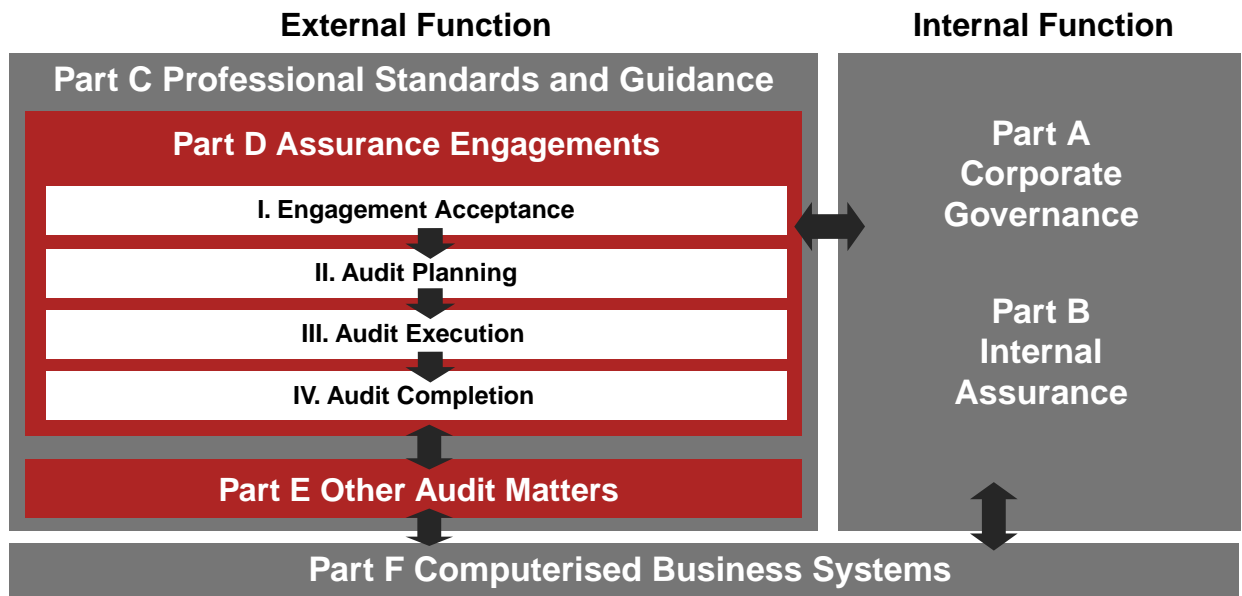
In addition, you will find at the end of the Learning Pack a bank of past HKICPA case-study style questions. These are past 'Section A' examination questions, which present a case study testing a number of different topics within the syllabus. These questions will provide you with excellent examination practice when you are in the revision phase of your studies, bringing together, as they do, the application of a variety of different topics to a scenario.

Please note that the Learning Pack is not intended to be a 'know-it-all' resource. You are required to undertake background reading including standards, legislation and recommended texts for the preparation for workshop and examination.

Module Structure









This module will enable you to perform effective assurance and related assignments. You will also understand the importance of corporate governance and be able to ensure it has been effectively set up in an organisation. Please refer to the QP Learning Centre for the six-month rule and examinable standards.

Overall Structure of Module C (Business Assurance)



Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list	Tells you what you will be studying in the chapter. The topic items form the numbered headings within the chapter.
Learning focus	Puts the chapter topic into perspective and explains why it is important, both within your studies and within your practical working life.
Learning Outcomes	The list of Learning Outcomes issued for the Module by HKICPA, referenced to the chapter in the Learning Pack within which coverage will be found.
Topic highlights 	Summarise the key content of the particular section that you are about to start. They are also found within sections, when an important issue is introduced other than at the start of the section.
Key terms 	Definitions of important concepts. You really need to know and understand these before the examination, and understanding will be useful at the workshops too.
Examples 	Illustrations of particular techniques or concepts with a worked solution or explanation provided immediately afterwards.
Case study 	An example or illustration not requiring a solution, designed to enrich your understanding of a topic and add practical emphasis. Often based on real world scenarios and contemporary issues.
Self-test questions 	These are questions that enable you to practise a technique or test your understanding. You will find the answer at the end of the chapter.
Formula to learn 	You may be required to apply financial management formulae in Module B, Corporate Financing.
Topic recap	Reviews and recaps on the key areas covered in the chapter.
Exam practice 	A question at the end of the chapter to enable you to practise the techniques that you have learned. In most cases this will be a past HKICPA examination question, updated as appropriate. You will find the answers in a bank at the end of the Learning Pack entitled Answers to Exam Practice Questions.
Further reading 	In Modules B and D you will find references to further reading that will help you to understand the topics and put them into the practical context. The reading suggested may be books, websites or technical articles.
Bold text	Throughout the Learning Pack you will see that some of the text is in bold type. This is to add emphasis and to help you to grasp the key elements within a sentence or paragraph.

Learning outcomes

HKICPA's learning outcomes for the Module are set out below. They are cross-referenced to the chapter in the Learning Pack where they are covered.

Fields of competency

The items listed in this section are shown with an indicator of the minimum acceptable level of competency, based on a three-point scale as follows

- 1 Awareness
To have a general professional awareness of the field with a basic understanding of relevant knowledge and related concepts.
- 2 Knowledge
The ability to use knowledge to perform professional tasks competently without assistance in straightforward situations or applications.
- 3 Application
The ability to apply comprehensive knowledge and a broad range of professional skills in a practical setting to solve most problems generally encountered in practice.

Topics

		Competency	Chapter where covered
LO1. Professional standards and guidance			
Identify and where appropriate apply ethical standards, legislation and professional guidance:			
LO1.01	The Institute's Code of Ethics for Professional Accountants:	3	
	1.01.01 Explain the fundamental principles and the conceptual framework approach		4
	1.01.02 Identify, evaluate and respond to threats to compliance with the fundamental principles		4
	1.01.03 Discuss and evaluate the effectiveness of available safeguards		4
	1.01.04 Recognise and advise on conflicts in the application of fundamental principles for Professional Accountants in practice and in business		4
LO1.02	Professional standards and guidance:	3	
	1.02.01 Explain the importance of adherence to professional standards and guidance		5
LO1.03	Legal and regulatory framework governing the profession:	3	
	1.03.01 Explain the regulatory framework for assurance and non-assurance engagements in Hong Kong		5
	1.03.02 Explain the nature and purpose of assurance and non-assurance engagements		5

		Competency	Chapter where covered
LO2. Assurance engagements			
Apply relevant Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services, guidance and legislation to plan, perform and complete assurance engagements including the audits of financial statements with emphases on:			
LO2.01	Audit requirements for a complete set of general purpose financial statements	3	
LO2.02	Other assurance engagement requirements:	2	
2.02.01	Identify the level of assurance and the issues relating to other assurance and non-assurable engagements, including:		19
2.02.01.01	Reviews		19
2.02.01.02	Agreed-upon procedures		19
2.02.01.03	Pro-forma financial information		19
2.02.01.04	Investment circular reporting engagements		19
2.02.01.05	Preliminary announcements of annual results		19
2.02.01.06	Comfort letters		19
2.02.01.07	Due diligence work		19
LO2.03	Client and engagement acceptance procedures:	3	
2.03.01	Explain the reasons why entities change their auditors/professional accountants		7
2.03.02	Explain the requirements relating to the appointment of auditors under the Hong Kong Companies Ordinance		7
2.03.03	Explain the procedure for a change of auditors		7
2.03.04	Explain the rights of the auditors in the process of a change of auditors		7
2.03.05	Explain the professional clearance procedures		7
2.03.06	Explain the matters to be considered and the procedures that an audit firm/professional accountant should carry out before accepting a specified new client/engagement including:		7
2.03.06.01	Client acceptance		7
2.03.06.02	Engagement acceptance		7
2.03.06.03	Agreement of the terms of engagement		7
2.03.07	Identify the issues relating to the agreement of the scope and terms of an engagement with a client		7

		Competency	Chapter where covered
	2.03.08 Explain the procedures for the transfer of books, papers and information following a new appointment		7
LO2.04	Audit methodologies:	3	
	2.04.01 Describe the key features of the following audit methodologies:	3	
	2.04.01.01 Risk-based auditing		9
	2.04.01.02 Top-down auditing		9
	2.04.01.03 System-based auditing		9
	2.04.01.04 Systems audit		9
	2.04.01.05 Balance sheet approach		9
	2.04.01.06 Transaction cycle approach		9
	2.04.01.07 Directional testing		9
	2.04.02 Understand the cost and performance efficiency of different audit methodologies	2	
LO2.05	Planning and risk assessment:	3	
	2.05.01 Identify and explain:		
	2.05.01.01 The need for planning an audit		8
	2.05.01.02 The contents of the overall audit strategy and the audit plan		8
	2.05.01.03 The relationship between the overall audit strategy and the audit plan		8
	2.05.02 Develop and document an audit plan		8
	2.05.03 Explain how auditors obtain an initial understanding of the entity and its environment including the use of preliminary analytical review procedures		8
	2.05.04 Explain the components of audit risk		8
	2.05.05 Assess the risk of material misstatement at the financial statement level and assertion level		8
	2.05.06 Recognise and suggest overall responses to assessed risk		8
	2.05.07 Recognise and suggest specific procedures to respond to assessed risks		8
	2.05.08 Explain the effect of fraud and misstatements on audit planning and work		10
	2.05.09 Explain the effect of law and regulations, and non-compliance therewith, on audit planning and procedures		10

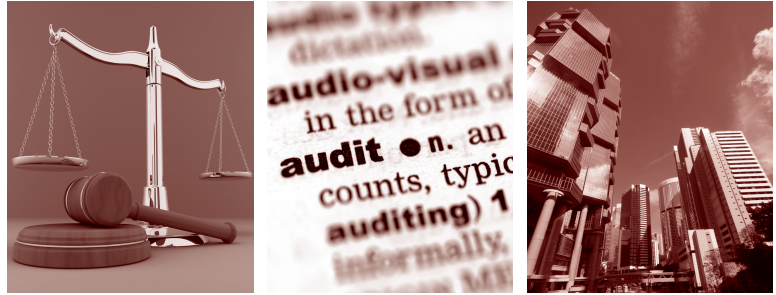
		Competency	Chapter where covered
LO2.06	Quality control considerations:	3	
	2.06.01 Explain the principles and purposes of quality control of audit and other assurance engagements		6
	2.06.02 Identify the features of a system of quality control relevant to a specific firm		6
	2.06.03 Choose and explain quality control procedures that are relevant to a specific audit engagement		6
	2.06.04 Assess and explain whether an engagement has been performed in line with professional standards and whether reports issued are appropriate		6
LO2.07	Documentation:	3	
	2.07.01 Document an audit plan		8
	2.07.02 Explain the need for and the importance of audit documentation		9
LO2.08	Materiality:	3	
	2.08.01 Define materiality and demonstrate how it should be applied in the context of financial reporting and auditing		8
LO2.09	Audit procedures:	3	
	2.09.01 Define audit sampling		9
	2.09.02 Explain the need for sampling		9
	2.09.03 Apply the basic principles of sampling		9
	2.09.04 Assess and explain the results of sampling		9
	2.09.05 Explain the importance of internal control to auditors and the execution of tests of control		3,11
	2.09.06 Explain how auditors identify weaknesses in internal control systems and how those weaknesses limit the extent of auditors' reliance on those systems		11
	2.09.07 Explain the types of substantive procedures and the issues in evaluating the results obtained		12
	2.09.08 Explain what is meant by analytical review and how analytical review procedures are used in an audit		12
	2.09.09 Explain the appropriate audit tests for:		
	2.09.09.01 Tangible non-current assets		13
	2.09.09.02 Intangible non-current assets		13
	2.09.09.03 Inventory		13
	2.09.09.04 Receivables		13
	2.09.09.05 Bank and cash		13

		Competency	Chapter where covered
	2.09.09.06	Trade payables and accruals	13
	2.09.09.07	Non-current liabilities	13
	2.09.09.08	Provisions and contingencies	13
	2.09.09.09	Capital and other issues	13
	2.09.09.10	Long-term investments	13
	2.09.09.11	Segment information	13
	2.09.09.12	Revenue	13
	2.09.09.13	Purchases	13
	2.09.09.14	Wages and salaries	13
2.09.10	Discuss the audit problems and identify procedures for the audit of:		
	2.09.10.01	Accounting estimates	15
	2.09.10.02	Fair values	15
	2.09.10.03	Opening balances	15
	2.09.10.04	Comparatives	15
	2.09.10.05	Related party transactions	16
2.09.11	Recognise and explain the issues relating to the audit of a group of companies		18
LO2.10	Audit evidence:		3
	2.10.01	Explain the procedures by which audit evidence may be obtained	3 9
	2.10.02	Assess the appropriateness and sufficiency (relevance and reliability) of different sources of audit evidence	3 9
	2.10.03	Explain the assertions contained in the financial statements and their use in obtaining evidence	3 9
	2.10.04	Explain the need to modify the audit strategy and audit plan following the results of tests of control	3 11
	2.10.05	Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations	2 14
LO2.11	Internal audit:		2
	2.11.01	Explain the relationship between internal auditors and external auditors	3
	2.11.02	Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations	3, 14

		Competency	Chapter where covered
LO2.12	Completion procedures:	3	
2.12.01	Explain the purpose of and procedures to be used in:		
2.12.01.01	A subsequent events review		16
2.12.01.02	A going concern review		16
2.12.01.03	Obtaining written representations from management		16
2.12.01.04	Review of report by other auditors to principal auditors of a group of companies		18
2.12.01.05	Overall review of the financial statements		16
2.12.01.06	Review of other published information		16
2.12.02	Explain the procedures required to identify and audit related party transactions		16
2.12.03	Explain the need to evaluate misstatements identified during the audit		16
2.12.04	Explain the follow up on illegal act or fraud found while performing an audit especially in the case of money laundering or corruption		10, 16
LO2.13	Reporting:	3	
2.13.01	Discuss and provide examples of how the reporting of internal control weaknesses and recommendations to overcome those weaknesses are provided to management		11
2.13.02	Explain the requirement for an auditor to report to management or those charged with governance		16
2.13.03	Explain and analyse the format and content of unmodified audit reports		17
2.13.04	Explain and analyse the format and content of modified audit reports		17
LO3. Corporate governance			
Describe current developments and issues in corporate governance and explain the impact that it will have on management, assurance engagements and auditors' responsibilities:			
LO3.01	Background to corporate governance developments:	2	
3.01.01	Explain the objectives, concepts, relevance and importance of corporate governance		1
3.01.02	Discuss the provisions of international codes of corporate governance (such as OECD) that are most relevant to auditors		1

		Competency	Chapter where covered
	3.01.03 Explain corporate governance developments in Hong Kong and the structure of the Code on Corporate Governance Practices and Corporate Governance Report in Hong Kong		2
LO3.02	Key issues relating to corporate governance including directors' remuneration, board composition, audit committee and non-controlling interests:	2	
	3.02.01 Explain the concept of stakeholder theory in corporate governance		1
	3.02.02 Describe the corporate governance requirements as set out in the Companies Ordinance and Hong Kong Stock Exchange Listing Requirements relating to directors' responsibilities (for example, risk management and internal control) and the reporting responsibilities of auditors		2
LO3.03	Management's responsibilities to comply with corporate governance requirements and to implement related practices:	3	
	3.03.01 Explain the responsibilities of management within the corporate governance framework		2
	3.03.02 Analyse the structure and roles of board committees and discuss their drawbacks and limitations		2
LO3.04	Auditors' responsibilities to consider and address corporate governance requirements:	3	
	3.04.01 Explain the auditor's responsibility to consider and address corporate governance requirements		2
LO3.05	Implications of overseas legislation such as the Sarbanes-Oxley Act 2002 on Hong Kong companies and auditors:	2	
	3.05.01 Explain the effect of the Sarbanes-Oxley Act on Hong Kong companies and their auditors		3
LO4. Computerised business systems			
Discuss the features of computerised business systems and assess and advise on risk and control frameworks:			
LO4.01	Key features of a computerised business system:	3	
	4.01.01 Explain the characteristics of an entity operating a networked computer system		20
	4.01.02 Explain the characteristics of an entity operating with standalone PCs		20
LO4.02	Categories and types of controls:	3	
	4.02.01 State examples of controls in a computerised system		11, 20
	4.02.02 Define and give examples of general and application controls		11, 20

		Competency	Chapter where covered
LO4.03	Impact of increasing use and share of ownership by accountants in corporate information system	2	20
LO4.04	Impact of e-commerce:	3	
	4.04.01 Recognise and discuss the importance of e-commerce to a business		20
	4.04.02 Identify and explain the effect of e-commerce on the auditor's risk assessment and audit approach		20
	4.04.03 Identify the knowledge and skills required to audit an entity's e-commerce activities		20
LO4.05	Opportunities and threats to corporate information system including capabilities in data treatment and analysis, data integrity, system security and issues in access restriction, and business contingency/continuity	2	20
LO4.06	Risk and control framework:	3	
	4.06.01 Explain the audit problems of an entity operating a networked computer system		20
	4.06.02 Explain the audit problems of an entity operating with standalone PCs		20
LO4.07	Internal audit:	3	
	4.07.01 Explain the ways in which internal audit is of particular significance in a computerised accounting system		20
	4.07.02 Identify the procedures that an auditor may have to undertake to assess the role of internal audit		20
LO4.08	System change processes:	2	
	4.08.01 Explain the potential impact on the auditor where an entity changes its computerised system		20
LO4.09	Risk assessment and evaluation of IT processes:	2	
	4.09.01 Identify what factors the auditor may need to consider in assessing the audit risk of a computerised environment		20
	4.09.02 Describe the use of computer-assisted audit techniques (CAAT) in an audit		20

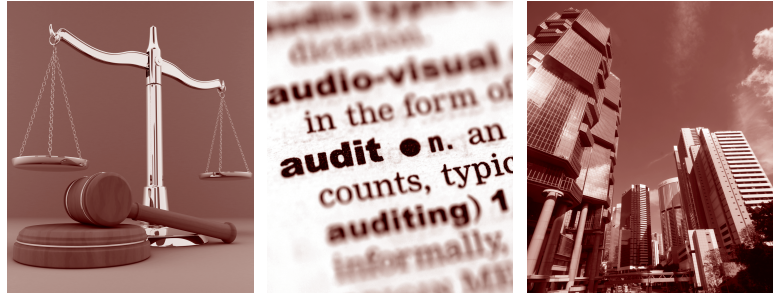


Part A

Corporate governance

This Part explains the importance and implication of corporate governance in an assurance process.

Practical situations and requirements for good corporate governance are also discussed and presented.



chapter 1

Scope of corporate governance

Topic list

- 1 Codes of corporate governance**
 - 1.1 What is corporate governance?
 - 1.2 Contribution of corporate governance codes
 - 1.3 Elements of corporate governance
 - 1.4 Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance
 - 1.5 Corporate governance concepts
 - 1.6 HKICPA Guide on corporate governance
- 2 Corporate governance and agency**
 - 2.1 Nature of agency
 - 2.2 Accountability and fiduciary responsibilities
 - 2.3 The agency problem
 - 2.4 Resolving the agency problem: alignment of interests
- 3 Stakeholders in corporate governance**
 - 3.1 Stakeholders
 - 3.2 Stakeholder theory
 - 3.3 Classifications of stakeholders
 - 3.4 Reconciling viewpoints of different stakeholders
 - 3.5 Stakeholder and agency theory
- 4 Major issues in corporate governance**
 - 4.1 Duties of directors
 - 4.2 Composition and balance of the board
 - 4.3 Reliability of financial reporting and external auditors
 - 4.4 Directors' remuneration and rewards
 - 4.5 Responsibility of the board for risk management and internal control systems
 - 4.6 Rights and responsibilities of shareholders
 - 4.7 Corporate social responsibility and business ethics
 - 4.8 Public and non-governmental bodies' corporate governance
 - 4.9 The driving forces underlying the governance code development
 - 4.10 Development of corporate governance codes
- 5 Corporate social responsibility**
 - 5.1 Significance of social corporate responsibility
 - 5.2 Corporate social responsibility and stakeholders
 - 5.3 Impact of corporate social responsibility on strategy and corporate governance
 - 5.4 Ownership and corporate social responsibility

Learning focus

Corporate governance is the system by which a company is directed and controlled. There are a number of separate codes of corporate governance with which companies must be familiar.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
3.01	Background to corporate governance developments	2
3.01.01	Explain the objectives, concepts, relevance and importance of corporate governance	
3.01.02	Discuss the provisions of international codes of corporate governance (such as the OECD) that are most relevant to auditors	
3.02	Key issues relating to corporate governance including directors' remuneration, board composition, audit committee and non-controlling interests	2
3.02.01	Explain the concept of stakeholder theory in corporate governance	

1 Codes of corporate governance



Topic highlights

There is no single definition of what corporate governance really means. The most widely accepted definition is defined by the UK Cadbury Committee Report (1992) as the “system by which a company is directed and controlled”. It can also be considered as the “set of relationships between the management, the Board of Directors (BOD), the shareholders as well as other stakeholders to the corporation” (HKICPA, 2006). It is needed because of the **agency problem**: this arises due to the separation of ownership and control of the company, ie the owners of a company and the people who manage it are not always the same.

1.1 What is corporate governance?



Key terms

Corporate governance is the system by which companies are directed and controlled. Linked to corporate governance is **Stewardship**, which refers to taking care of something (the company and its assets) which is owned by someone else (shareholders).

Corporate governance includes managing the relationships among the many parties interested in an entity and providing transparent, responsible management practices to meet the entity's objectives. The first corporate governance code was the Cadbury Report, published in the UK in 1992. This identified a number of internal and external parties who hold an interest in the effective corporate governance of an entity:

- **Directors:** responsible for corporate governance
- **Shareholders:** linked to the directors as users of the financial statements and as individuals who stand to directly benefit financially from the activities of the entity
- **Other relevant parties:** these may be numerous but include employees, customers, suppliers, the tax authorities and any special interest groups, regulators, and the wider public.

1.1.1 The importance of corporate governance

Companies differ in the degree of shareholder involvement; in some companies, **shareholders** are **well informed** about the direction of and **management** of the business because they hold positions as directors and directly influence day-to-day management such as “insider company”. But in companies where the shareholders are not employed to manage the business (ie “outsider company”), they may only have a limited opportunity to find out about the management of the company, usually at the **AGM (annual general meeting)**.

AGMs are notoriously poorly attended which adds to the **agency problem discussed in more detail later**. This arises when shareholders, who are actually the **owners** of the company (the principals), delegate decision-making authority for the **day-to-day operations to the directors and other senior management** (the agents). Since the interests of management may not always be in line with those of shareholders, management may act in a way that is detrimental to the interests of the shareholders. Even though management submit the company's results for shareholders' approval at the AGM, poor turnout and little involvement in day-to-day matters means this is usually only a matter of rubber stamping the proposals put forward by management. It is also very unusual for the directors to be challenged on any key areas such as compensation packages.

As a result, there is the **potential for conflicts of interest** between management and shareholders.

The current framework of corporate governance in Hong Kong and China lays down both statutory and non-statutory requirements as to how directors should run a business to best enhance and keep in balance stakeholders' interests. Statutory requirements consist of the Companies Ordinance, Securities (Disclosure of Interests) Ordinance, Securities (Insider Dealing) Ordinance, and Takeover Codes. Non-statutory requirements are those specified by the Hong Kong Stock Exchange relating to Listing Rules and Code of Corporate Governance Practice. The Hong Kong Code is based on the UK Combined Code of July 2003, which was renamed as the UK Corporate Governance Code in 2010, with additional rules on connected transactions and non-controlling interests, together with changes that tailor the approach to the Hong Kong environment (family control and Mainland Enterprises).

There are a number of different facets to corporate governance:

- Commitment to ethical values
- Transparency in company activities
- Managing stakeholders' interests
- Safeguarding of the company's assets
- Establishing strong internal controls to deter and detect fraud
- Ensuring the efficient use of resources to create and enhance shareholder value
- Accountability, which ultimately rests with the directors and those charged with governance.

Good corporate governance is essential in today's global business environment, and especially so in Hong Kong, if the Territory is to maintain its competitive status as **one of the world's major financial centres**, in addition to acting as a premier international capital market for Mainland China and the region.

In summary, it is necessary for processes to be in place in every entity to ensure that the interests of every stakeholder are safeguarded. It is a fiduciary duty of management that they act in the best interests of the shareholders, employees and the external parties to whom they are accountable.

1.2 Contribution of corporate governance codes

Investors are often **prepared to pay a premium** to invest in a company with good corporate governance practices in place. The individual provisions of the Codes have undoubtedly made a number of contributions to the corporate environment:

- (a) The reports have **highlighted the contributions good corporate governance** can make to companies.
- (b) The codes have **emphasised certain risks** that have contributed to corporate governance failure, for example individual directors having too great an influence.
- (c) The provisions have **provided benchmarks** that can be used to judge the effectiveness of internal controls and risk management systems.
- (d) The guidelines have **promoted specific good practice** in a number of areas, for example non-executive directors, performance-related pay and disclosure.
- (e) The recommendations have highlighted the importance of basic concepts and highlighted how these can be put into practice, for example **accountability** through recommendations about organisation-stakeholder relationships and **transparency** by specifying disclosure requirements.

In Hong Kong

In Hong Kong, the Code on Corporate Governance Practices ("HK Code") sets out the principles of good corporate governance. It refers to the companies subject to the Code as "issuers". The HK Code was launched in January 2005 and requires listed issuers to report regularly their corporate governance performance in their financial reports. With the collective and concerted efforts made

by all market participants, the overall standard of corporate governance in Hong Kong has been improving.

There are two levels of recommendations:

- (a) Code provisions
- (b) Recommended best practices.

Hong Kong listed companies are expected to comply with the provisions of the Code, but may choose to deviate from them. If they deviate then they need to explain why in the annual report, this is called the “**comply or explain approach**”. The recommended best practices are for guidance only, although companies are encouraged to comply. Hong Kong companies may also devise their own code on corporate governance practices on such terms as they may consider appropriate.

In late 2010, The Hong Kong Stock Exchange published its “Consultation Conclusions on Review of the Corporate Governance Code and Associated Listing Rules” (Consultation Conclusions). The Consultation Papers contain proposals to amend the Corporate Governance Code (as renamed) and the Rules pertaining to corporate governance.

The consultation period ended in March 2011 where the Hong Kong Stock Exchange adopted most of the proposals outlined in the Consultation Paper, subject to certain modifications as set out in the Consultation Conclusions.

The amendments will keep the Corporate Governance Code in line with international best practice. In its first interim/half year or annual report covering a period after 1 April 2012, the issuer must state, in that report, whether it has, for that period, complied with the Code Provisions in the revised Code as well as those of the former Code. Issuers may adopt the revised Code at an earlier date than 1 April 2012.

1.3 Elements of corporate governance

There are a number of elements in corporate governance:

- (a) The management, awareness, evaluation and mitigation of **risk** is fundamental in all definitions of good governance. This includes the operation of an **adequate and appropriate system of control**.
- (b) The notion that **overall performance is enhanced by good supervision and management** within **set best practice guidelines** underpins most definitions.
- (c) Good governance provides a **framework** for an organisation to pursue its strategy in an **ethical and effective** way and **offers safeguards against misuse of resources**, human, financial, physical or intellectual.
- (d) Good governance is not just about externally established codes, it also requires a willingness to **apply the spirit** as well as the letter of the law.
- (e) Good corporate governance can **attract new investment** into companies, particularly in developing nations.
- (f) **Accountability** is generally a major theme in all governance frameworks, including accountability not just to shareholders but also other **stakeholders**.
- (g) Corporate governance **underpins capital market confidence in companies** and in the government/regulators/tax authorities that administer them.

1.4 Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance



Topic highlights

The **OECD Principles of Corporate Governance** set out the rights of shareholders, the importance of disclosure and transparency and the responsibilities of the board of directors.

An important question to consider is “will the same way of managing companies be the best method for all companies?” The answer is likely to be no. Companies are different from each other, and globally, they operate in **different legal systems with different institutions**, frameworks and traditions. It would not be possible to construct one single approach to operating companies that could be described as best practice for all.

The key issue in corporate governance is that “a high degree of priority [is] placed on the interests of shareholders, who place their trust in corporations to use their investment funds wisely and effectively”. Shareholders in a company might be a family, they might be the general public or they might be institutional investors representing, in particular, people's future pensions. These shareholders will vary in their degree of interaction with the company and their directors.

Codes such as the OECD Code have been developed from best practice in a number of jurisdictions. As such, they can be seen as **representing an international consensus** on common elements that underlie good corporate governance. They stress global issues that are important to companies operating in a number of jurisdictions. The OECD Code for example, emphasises the importance of **eliminating impediments to cross-border shareholdings** and **treating overseas shareholders fairly**.

In the context of this great variety in the basic element of these companies, the OECD has established a number of **Principles of Corporate Governance**, which were issued in 1999 and reviewed in 2004, and which serve as a **reference point** for countries (to develop corporate governance codes if they wish) and companies. They were developed in response to a mandate given to the OECD to develop a set of standards and guidelines on good corporate governance.

OECD Principles of Corporate Governance

- I The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.
- II The corporate governance framework should protect shareholders' rights.
- III The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- IV The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.
- V The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- VI The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

The above Principles are non-binding on countries and companies. Rather they seek to identify objectives and various means for achieving them. Their purpose is to serve as a reference point that can be used by policy makers to analyse and develop their own legal and regulatory frameworks for corporate governance, given their individual mixes of economic, social and legal circumstances.

In order to obtain the best of the advantages and avoid the worst disadvantages, countries may take a hybrid approach and make some elements of corporate governance mandatory and some voluntary.



Self-test question 1

Keepalive Life Assurance Company is a mutual organisation, owned by its policyholders. Owing to changes in capital adequacy requirements imposed by the regulator and pressure from lobby groups, it has decided to convert to a public limited company and float on the stock exchange.

The board of directors is anxious to ensure that the very highest standards of governance are adopted in the transition to the new corporate form. It has decided to review the scope of its policies in this respect.

The policyholders, who own the voting rights in the company, have expressed concerns about the company's plans for several reasons. First, some doubt that the existing directors have the experience necessary to manage the company in the new form. Many of the directors only have experience in the life assurance industry and have been with the company for a long time. The two previous chief executives remain on the board. Second, the company had to increase its provisions for losses last year, causing an embarrassing admission by the board that the financial statements were “distorted”. One major investor has accused the board of a “clear lack of probity”. Third, when the company is floated it is likely that its shares will be purchased by a few very large institutional investors who may force the company to adopt a less “customer friendly” approach to business. At the moment, the company offers many investment products that are highly valued by smaller, less wealthy customers but apparently make little profit for the company.

- (a) With reference to an appropriate framework, such as the one proposed by the OECD, explain the matters that the board of directors of Keepalive Life Assurance Company should consider in its review of corporate governance arrangements.
- (b) Explain what is meant by “lack of probity” and why probity is important.

(The answer is at the end of the chapter)

1.5 Corporate governance concepts

1.5.1 Fairness

The directors' deliberations and also the systems and values that underlie the company must be **balanced** by taking into account everyone who has a legitimate interest in the company, and respecting their rights and views. In many jurisdictions, corporate governance guidelines reinforce legal protection for certain groups, for example minority shareholders.

1.5.2 Openness and transparency



Key term

Transparency means **open and clear disclosure** of relevant information to shareholders and other stakeholders, and not concealing information which may affect decision-making. It means open discussion, with a default position of information provision rather than concealment.

Disclosure in this context obviously includes information in the financial statements, not just the numbers and notes to the financial statements but also narrative statements such as the directors' report and the operating and financial review. It also includes all **voluntary disclosure**, that is disclosure above the minimum required by law or regulation. Voluntary corporate communications include management forecasts, analysts' presentations, press releases, information placed on websites and other reports such as stand-alone environmental or social reports.

The main reason why **transparency** is so important relates to the agency problem (the potential conflict between owners and managers). This will be discussed further in section 2 of this chapter.

Without effective disclosure the position could be unfairly weighted towards managers, since they have far more knowledge of the company's activities and financial situation than owner/investors. Avoiding the creation of an **information asymmetry between managers and owners** requires not only effective disclosure rules, but strong internal controls that ensure the reliability of information disclosures.

Linked with the agency issue, publication of relevant and reliable information **underpins stock market confidence** in how companies are being governed and thus **significantly influences market prices**. **International Financial Reporting Standards (IFRSs)**, **Hong Kong Financial Reporting Standards (HKFRSs)**, and **stock market regulations** based on corporate governance codes require published financial statements to present a **true and fair view**. Information can only fulfil this requirement if adequate disclosure is made of uncertainties and adverse events.

Circumstances where restricted disclosure may be justified include discussions about **future strategy** (knowledge of which would benefit competitors), **confidential** issues relating to **individuals** and discussions leading to an agreed position that is then made public.

1.5.3 Independence

Independence is an important concept in relation to directors. Corporate governance reports have increasingly stressed the importance of **independent non-executive directors**; directors who are not primarily employed by the company and who have very strictly controlled other links with it. As a result they should be free from conflicts of interest and in a better position to **promote the interests of shareholders and other stakeholders**. Freed from pressures that could influence their activities, independent non-executive directors should be able to carry out **effective monitoring** of the company in conjunction with equally independent external auditors on behalf of shareholders.

Non-executive directors' lack of links and limits on the time that they serve as non-executive directors should promote **avoidance of managerial capture** – accepting executive managers' views on trust without analysing and questioning them.

In the Hong Kong context, the Hong Kong Stock Exchange Listing Rules specify that there must be at least three independent non-executive directors on the main board for listed companies.

1.5.4 Probity and honesty

Hopefully this should be the most self-evident of the principles, relating not only to telling the truth, but also not **misleading** shareholders and other stakeholders by presenting information in a biased way.

Probity can be defined in terms of receipt of gifts or hospitality by trustees. The Code stresses that all gifts should be clearly recorded, and trustees should not accept gifts with a significant monetary value or lavish hospitality. They should certainly not accept gifts or hospitality which may seem likely to influence their decisions.

1.5.5 Responsibility

Responsibility means management accepting the credit or blame for governance decisions.

Management theories stress that for management to be held properly responsible, there must be a system in place that allows for **corrective action** and **penalising mismanagement**. Responsible management should act in the best interests of the company and take the necessary steps to ensure the company stays on the right path.

The board of directors must act responsibly to, and with responsibility towards, all stakeholders of the company. However, the responsibility of directors to other stakeholders, both in terms of to **whom** they are responsible and the **extent** of their responsibility, remains a key point of contention in corporate governance debates. We shall discuss the importance of stakeholders later in this chapter.

1.5.6 Accountability



Key term

Corporate **accountability** refers to whether an organisation (and its directors) are answerable in some way for the consequences of their actions.

Accountability of directors to shareholders has always been an important part of company law, well before the development of the corporate governance codes. For example, companies have been required to provide **financial information** to shareholders on an **annual basis** and hold **annual general meetings**. However, particularly because of the corporate governance scandals of the last 30 years, investors have demanded greater assurance that directors are acting in their interests.

This has led to the development of corporate governance codes, which we shall consider in the next chapter. The UK Cadbury Report stresses that making the accountability work is the responsibility of **both** parties. Directors, as we have seen, do so through the quality of information that they provide whereas shareholders do so through their willingness to **exercise their responsibility as owners**, which means using the available mechanisms to query and assess the actions of the board.

As with responsibility one of the biggest debates in corporate governance is the extent of management's **accountability** towards **other stakeholders** such as the community within which the organisation operates. This has led on to a debate about the contents of financial statements themselves; for what should financial statements actually account.

1.5.7 Reputation

An organisation's reputation depends on how likely other risks are to crystallise. In the same way directors' concern for an organisation's reputation will be demonstrated by the extent to which they fulfil the other principles of corporate governance. There are purely **commercial reasons** for promoting the organisation's reputation, that the price of publicly traded shares is often dependent on reputation and hence reputation is often a very valuable asset of the organisation.

1.5.8 Judgment

Judgment means the board **making decisions that enhance the prosperity** of the organisation. This means that board members must acquire a broad enough knowledge of the **business and its environment** to be able to provide meaningful direction to it. This has implications not only for the attention directors have to give to the organisation's affairs, but also the way the directors are recruited and trained.

The complexities of senior management mean that the directors have to bring **multiple conceptual skills** to management that aim to maximise long-term returns. This means that corporate governance can involve balancing many competing people and resource claims against each other; although, as we shall see, risk management is an integral part of corporate governance, corporate governance is not just about risk management.

1.5.9 Integrity



Key term

Integrity means **straightforward dealing and competence**. Financial reporting should be honest and should present a balanced picture of the state of the company's affairs. The integrity of reports depends on the integrity of those who prepare and present them.

Integrity can be taken as meaning someone of **high moral character**, who sticks to principles no matter the pressure to do so otherwise. In working life this means adhering to principles of professionalism and probity. **Straightforward dealing in relationships** with the different people and constituencies whom you meet is particularly important; trust is vital in relationships and belief in the integrity of those with whom you are dealing underpins this. The Cadbury Report definition highlights the need for **personal honesty and integrity** of preparers of financial statements. This implies qualities beyond a mechanical adherence to accounting or ethical regulations or guidelines. At times accountants will have to use judgment or face financial situations which aren't covered by regulations or guidance, and on these occasions integrity is particularly important.

Integrity is an essential principle of the **corporate governance relationship**, particularly in relationship to representing shareholder interests and exercising agency. As with financial reporting guidance, ethical codes don't cover all situations and therefore depend for their effectiveness on the qualities of the accountant. In addition, we have seen that a key aim of corporate governance is to inspire confidence in participants in the market and this significantly depends upon a **public perception of competence and integrity**.

1.6 HKICPA Guide on Corporate Governance

The HKICPA has published several study reports and practice guidance on corporate governance. The following are some of the more recent of these.

In **March 2001**, HKICPA issued the Guide **Corporate Governance Disclosure in Annual Reports** for the purpose to promote high standards of corporate governance disclosure in annual reports of Hong Kong companies, focusing especially on listed companies.

The **Guide** provided practical guidance and examples of corporate governance disclosures that would fulfil the regulatory requirements at that time in Hong Kong. It also included additional recommended disclosures that went beyond the rules and regulations of the time and provided illustrations and examples to show how such voluntary disclosures might be presented.

The following is the summary of the major recommendations:

Statement on corporate governance	Listed companies and other companies are encouraged to include a statement of corporate governance in their annual report for communicating to stakeholders. The content includes information on directors and committees, investor relations and other matters such as corporate social responsibility.
Directors' remuneration	In order to enhance comparability and transparency of directors' remuneration, detailed disclosure is required for directors' remunerations such as performance-related pay and non-performance related pay. The remuneration should be disclosed by individual name of director.
Disclosure of standard remuneration and directors' share options	Directors' standard remuneration should be analysed and details of directors' share options should be disclosed such as value of the share options.

Non-audit fees paid to the auditors

Disclosure of any non-audit fees should be disclosed as this would affect auditor's independence.

In **May 2004**, HKICPA issued the Guide **Corporate Governance for Public Bodies – a Basic Framework** for the purpose to provide a basic framework for public sector corporate governance and provide recommendation on good corporate governance.

It outlines a basic framework of corporate governance principles and recommended best practice for such organisations to adopt, as appropriate.

The Guide aims to assist governing boards, councils and management of public sector bodies to establish and maintain a clear focus on performance, transparency and accountability. It identifies **certain fundamental principles** expected of an organisation, namely openness, integrity and accountability, and key personal qualities required of governing board members, namely selflessness, integrity, objectivity, accountability, openness, honesty and leadership, and applied these principles and qualities to four dimensions of the governance of public sector organisations.

Standards of behaviour	<p>Ethical conduct – governing board members should endeavour to exemplify the personal qualities in their entirety</p> <p>Codes of conduct – a formal code of ethical conduct should be in place to define standards of acceptable conduct for governing board members and employees</p>
Organisational structures and processes	<ul style="list-style-type: none"> (i) Accountability to stakeholders – directors are accountable to stakeholders for complying with statutory and regulatory requirements, safeguarding funds and taking proper stewardship of assets and resources (ii) Commitment to openness and transparency – the governing board in all of the main activities of the organisation (iii) Roles and responsibilities of the board, committees, chairman, non-executive directors should be clearly disclosed in the annual report (iv) Overall human resources policy – there should be effective policies and procedures to recruit, retain and train suitable staff
Risk management and control	<ul style="list-style-type: none"> (i) An effective system of internal control should be in place and operating effectively (ii) The governing board should have risk management and should consider the need of contingency plans as risk responses (iii) An effective internal audit function should be part of the framework of control (iv) An effective audit committee should be established (v) External auditor should be appointed to conduct an audit of financial statements for public sector organisations (vi) The governing board should maintain adequate oversight to ensure there are efficient budgeting and financial management

Accountability, reporting and disclosure	<ul style="list-style-type: none"> (i) Committees should have regular and informative reporting to the governing board (ii) Any major issues should be brought to the attention of the board on a timely basis (iii) An annual report incorporating financial statement should be published on a timely basis after the end of the financial year (iv) Appropriate accounting policies and standards should be adopted in preparation of financial statements (v) Financial and non-financial performance measures should be established and reported.
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The Guide draws reference from important overseas studies to provide a set of **recommendations that are suitable for the public sector environment in Hong Kong**. It should be applicable to most types of organisations in the public sector, and the recommendations contained therein can be tailored to the circumstances of individual organisations, depending on their size, complexity and resources.

In **June 2005**, HKICPA issued a Guide *Internal Control and Risk Management – a Basic Framework* for the purpose of providing a basic conceptual framework, general principles and recommendations for a **system of internal control and risk management**. It also outlines the responsibilities of the board and senior management in this regard, and the role that other parties, such as the audit committee and internal auditors, can play. It should help listed companies to understand and fulfil the requirements on internal controls contained in the revised Code on Corporate Governance Practices and the disclosure requirements of the new Corporate Governance Report (Main Board and the GEM Listing Rules, respectively).

The Guide also emphasises that establishing effective internal controls should not be seen as an exercise in compliance but is about putting in place processes that will help a business to **achieve its corporate objectives** and to **identify, assess and manage the significant risks** that could otherwise prevent it from doing so. It is also a question of being more **transparent and accountable** to shareholders and other stakeholders about how the business is being run.

In producing this Guide, the Institute has looked at conditions in Hong Kong and has drawn on important international benchmarks in this field, such as the report published in the US by the Committee of Sponsoring Organisations of the Treadway Commission, commonly known as COSO, and the Turnbull Guidance, which formed part of the Combined Code, now known as the UK Corporate Governance Code.

While the Guide is not intended to be exhaustive or prescriptive in nature, the Institute believes that the principles and recommendations contained therein will provide a useful reference for listed and group companies, as well as other companies that aim to implement or enhance their system of internal control.

In **December 2008**, HKICPA published a Guide *Defining and Developing an Effective Code of Conduct for Organisations*.

This was originally produced by the International Federation of Accountants (IFAC). Acknowledging its value to listed companies, public interest and other organisations, the Institute, together with the Hong Kong Stock Exchange, the Hong Kong Institute of Directors and the Hong Kong Ethics Development Centre, Independent Commission Against Corruption republished the guide with the addition of an explanatory foreword by the four bodies.

The Guide is designed to assist professional accountants, and the organisations in which they work, to develop a code of conduct of their own or to improve an existing code. While it does not aim to provide detailed and prescriptive terms that are applicable to all organisations, it sets out key principles and general guidance that should help all types of organisation to develop a more detailed code of conduct that takes account of their own individual circumstances.

The following are the key principles in the guide, demonstrating widely accepted good practice:

Values-based organisation and culture	The organisation's overarching objective should be to develop a values-based organisation and a values-driven code, to promote a culture that encourages employees to internalise the principle of integrity and practise it, and encourages employees to "do the right thing" by allowing them to make appropriate decisions.
Code of conduct reflects organisation context	A code of conduct reflects organisational context. The nature, title and content of an effective code will vary between organisations, as will the approach to its development.
Commitment from board of directors	<p>Ultimately, ethical responsibility lies with the board of directors (or its equivalent), the body that has power to influence an organisation's culture and behaviour.</p> <p>Boards should specifically oversee the development of the code of conduct (and a wider initiative to achieve a values-based organisation), and formally appoint a senior manager to supervise that development.</p>
Personnel	<p>A multi-disciplinary and cross-functional group including international personnel should lead code development where organisational size permits.</p> <p>Groups of employees and other key stakeholders can help to identify risks to corporate culture and business conduct and consider potential vulnerabilities arising from these risks and can usefully assist in defining and reviewing code content.</p>
Process for defining, developing and reviewing the code	Clearly identifying the established process for defining, developing and reviewing a code will promote understanding of, and agreement on, the key stages and activities.
Application across jurisdictions	A code of conduct should apply across all jurisdictions in which an organisation operates, unless contrary to local laws and regulations.
Continuous awareness and promotion	<p>Continuous awareness and promotion of the code and the wider approach to ethics and compliance is an important part of conveying management's commitment to their underlying principles. A continuous awareness programme should sustain interest in and commitment to the code.</p> <p>Employees and others should be made aware of the consequences of not adhering to the code.</p>

2 Corporate governance and agency



Topic highlights

Agency is extremely important in corporate governance as often the directors/managers are acting as agents for the owners (principals). Corporate governance frameworks aim to ensure directors/managers **fulfil their responsibilities** as agents by requiring disclosure and suggesting they are rewarded on the basis of performance.

2.1 Nature of agency



Key term

Agency relationship is a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf that involves delegating some decision-making authority to the agent. In other words, in a company, the shareholders are actually the owners (the principal) of the company, who delegate decision-making authority to the senior management (the agents). Since the interests of the managers are not always in line with those of shareholders, they may act in a way that is detrimental to the company as a whole.

There are a number of specific types of agent. These have either evolved in particular trades or developed in response to specific commercial needs. Examples include factors, brokers, estate agents, *del credere* agents, bankers and auctioneers.

2.2 Accountability and fiduciary responsibilities

2.2.1 Accountability



Key term

In the context of agency, **accountability** means that the agent is **answerable under the contract** to his principal and must account for the resources of his principal and the money he has gained working on his principal's behalf.

Two problems potentially arise with this:

- How does the principal **enforce this accountability** (the agency problem see below)? As we shall see, the corporate governance systems developed to monitor the behaviour of directors have been designed to address this issue; and
- What if the agent is **accountable to parties other than his principal** – how does he reconcile possibly conflicting duties?

2.2.2 Fiduciary duty

A legal definition of fiduciary duty is as follows:



Key term

Fiduciary duty is a duty imposed upon certain persons because of the **position of trust and confidence** in which they stand in relation to another. The duty is more onerous than generally arises under a contractual or tort relationship. It requires full disclosure of information held by the fiduciary, a strict duty to account for any profits received as a result of the relationship, and a duty to avoid conflicts of interest.

In Hong Kong, the general duties of directors are mainly found in case law (leaving aside certain specific obligations imposed by the Companies Ordinance and by the memorandum and articles of association of a company). Directors' duties can be classified into two broad categories: fiduciary duties, and duties of skill and care. For accountability purposes, the fiduciary duty is directly relevant. The fiduciary duties of directors, which are generally based on equitable principles, mainly include:

- (1) duty to act in good faith in the interests of the company
- (2) duty to exercise powers for proper purpose
- (3) duty to avoid conflicts of duty and interest

However, at present Hong Kong has still not codified any directors' duties into our Companies Ordinance, though the Registrar of Companies has issued several Non-statutory Guidelines on Directors' Duties in Hong Kong. By way of contrast, in the UK, the Companies Act 2006 introduced a statutory statement on directors' duties which covered specific general duties such as:

- (1) duty to act within powers
- (2) duty to promote the success of the company
- (3) duty to exercise independent judgment
- (4) duty to exercise reasonable care, skill and diligence
- (5) duty to avoid conflicts of interest
- (6) duty not to accept benefits from third parties
- (7) duty to declare interest to proposed transaction or arrangement

As such under the Hong Kong Companies Ordinance, directors owe a fiduciary duty to the company to exercise their powers *bona fide* in what they **honestly consider to be the interests of the company**. This duty is **owed to the company** and not generally to individual shareholders. In exercising the powers given to them by the constitution, the directors have a fiduciary duty not only to act *bona fide* but also only to use their powers **for a proper purpose**. The powers are restricted to the purposes for which they were given.

Clearly the concepts of fiduciary duty and accountability are very similar though not identical. Where certain wider responsibilities are enshrined in law, do directors have a duty to go beyond the law, or can they regard the law as defining what society as a whole requires of them?

2.2.3 Fiduciary relationship with stakeholders

Some management theorists have argued that **management bears a fiduciary relationship to stakeholders** and to the corporation as an abstract entity. It must act in the interests of the **stakeholders as their agent**, and it must act in the interests of the **corporation to ensure the survival** of the firm, safeguarding the long-term stakes of each group. Adoption of these principles would require significant changes to the way corporations are run. Some theorists, for example Silvia Ayuso, go on to propose a "**stakeholder board of directors**", with one representative for each of the stakeholder groups and one for the company itself. Each stakeholder representative would be elected by a stakeholder assembly. Companies law would have to develop to protect the interests of stakeholders.

2.3 The agency problem



Topic highlights

The agency problem arises from **separation of ownership from management** of the entity and can cause a conflict of interests if there is a **breach of trust** by directors by intentional action, omission, neglect or incompetence.

The agency problem arises when a principal hires an agent to perform in the interest of principal.

In listed companies the agency problem derives from the principals (shareholders) not being able to run the business themselves and therefore having to rely on agents (board of directors) to do so for them. This **separation of ownership from management** can cause a conflict of interest or moral hazard if there is a **breach of trust** by directors by intentional action, omission, neglect or incompetence. This breach may arise because the directors are **pursuing their own interests** rather than the shareholders (conflict of interest). Alternatively, the board of directors may undertake a risky project without considering carefully **the full consequences** as they have a different attitude to risk-taking to the shareholders (moral hazard).

For example, if managers hold none or very little of the equity shares of the company they work for, what is to stop them from working inefficiently, concentrating too much on achieving short-term profits and hence maximising their own bonuses? Without the incentive of equity ownership the agent may not look for profitable new investment and growth opportunities, or may over-consume perquisites such as high salaries and other benefits.

There are two possible approaches to aligning the interests between agent and principal, in order to remedy this agency problem. One would be to offer incentive plans such as stock options or equity in the company; the alternative would be to curb managerial controlling powers within the firm. Ultimately shareholders do possess the right to **remove the directors** from office. But shareholders have to take the initiative to do this, and in many companies they may lack the energy and organisation to take such a step. As a last resort, they can vote in favour of a takeover or removal of individual directors or entire boards, but this may be **undesirable** for other reasons.

2.4 Resolving the agency problem: alignment of interests

Agency theory sees employees of businesses, including managers, as individuals, each with his or her own objectives. Within a department of a business, there are departmental objectives. If achieving these various objectives leads also to the achievement of the objectives of the organisation as a whole, there is said to be **alignment of interests**.



Key term

Alignment of interests is accordance between the objectives of agents acting within an organisation and the objectives of the organisation as a whole. Alignment of interests is sometimes referred to as goal congruence, although goal congruence is used in other ways.

Alignment of interests may be better achieved and the “agency problem” better dealt with by giving managers the appropriate incentives, such as profit-related pay, or by providing more longer-term incentives that are related to the overall company performance. Examples of such remuneration incentives are:

- profit-related/economic value-added pay
- rewarding managers with shares
- executive share option plans

Such measures might merely encourage management to adopt more “**creative accounting**” methods which will distort the reported performance of the company in the service of the managers' own ends.

An alternative approach is to attempt to **monitor managers' behaviour**, for example by establishing “**management audit**” procedures, to introduce **additional reporting requirements**, or to seek **assurances** from managers that shareholders' interests will be foremost in their priorities. The most significant problem with monitoring is likely to be the **agency costs** involved, as they may imply **significant shareholder engagement** with the company.

3 Stakeholders in corporate governance



Topic highlights

Directors and managers need to be aware of the **interests of stakeholders** in governance issues.

Governance reports have emphasised the role of **institutional investors** (insurance companies, investment houses, or pension funds such as CalPers) in directing companies towards good corporate governance.

3.1 Stakeholders



Key term

Stakeholders are any entity (person, group or possibly non-human entity) that can **affect** or **be affected by** the achievements of an organisation's objectives. It is a **bi-directional** relationship. Each stakeholder group has different **expectations** about what it wants and different claims upon the organisation.

3.2 Stakeholder theory

Traditionally, the management of a company has a fiduciary duty to put the shareholders' interests first. The company converts the input from the investors, employees, and suppliers into goods to sell to the customer (output). By this model, companies only address the needs and wishes of those four parties: investors, employees, suppliers and customers.

Stakeholder theory proposes **corporate accountability** to a broad range of stakeholders. It is based on companies being so large, and their impact on society being so significant that they cannot just be responsible to their shareholders. Stakeholders should be seen not as just existing, but as **making legitimate demands** upon an organisation. The relationship should be seen as a **two-way** relationship.

What stakeholders want from an organisation will vary. Some will actively seek to influence what the organisation does; others may be concerned with limiting the effects of the organisation's activities upon themselves.

There is considerable dispute about whose interests should be taken into account. The **legitimacy of each stakeholder's claim** will depend on your ethical and political perspective on whether certain groups should be considered as stakeholders. Should, for example, distant (developing world) communities, other species, the natural environment in general or future generations be considered as legitimate stakeholders?

3.3 Classifications of stakeholders

Stakeholders can be classified by their proximity to the organisation:

Stakeholder group	Members
Internal stakeholders	Employees, management
Connected stakeholders	Shareholders, customers, suppliers, bankers, lenders, trade unions, competitors
External stakeholders	The government, local government (such as the council for a local district), the public, pressure groups, opinion leaders

There are other ways of classifying stakeholders.

3.4 Reconciling viewpoints of different stakeholders

Enlightened long-term value maximisation offers the best, fairest, method of reconciling the competing interests of stakeholders. Enlightened long-term value maximisation means pursuing profit maximisation, but with regard to **business ethics** and the **social consequences of the organisation's actions**. It is argued that the problem with traditional stakeholder theory is that it gives no indication of how to trade off competing interests; lacking measurable targets, managers are left unaccountable for their actions.

3.5 Stakeholder and agency theory

It is argued that agency theory does not allow managers to **avoid their normal moral obligations**, particularly avoiding harm to others, respecting the autonomy of others, telling the truth and honouring agreements. Only after fulfilling these can they maximise shareholder wealth. The agency-principal relationship can only be meaningful if managers attend to the moral principles.

An alternate view, supported by Classical Economics, is that managers are solely responsible for maximising the value of the firm for the owners. If managers are argued to have social responsibilities, then they have to act in some ways that are not in the best interests of the owners, **their principals**, and in ways that may reduce the value of the firm. They therefore are not acting properly as agents; instead they are in effect raising taxes and deciding how these taxes should be spent, which is the proper function of government, not agents.

4 Major issues in corporate governance



Topic highlights

Key issues in corporate governance reports have included the **role of the board**, the **quality of financial reporting and auditing**, **directors' remuneration**, **risk management** and **corporate social responsibility**.

We shall examine the major areas that have been affected by corporate governance.

4.1 Duties of directors

The corporate governance reports have aimed to build on the directors' duties as defined in statutory and case law. These include the **fiduciary duties** to act in the **best interests of the company**, use their powers for a **proper purpose**, **avoid conflicts of interest** and exercise a **duty of care**.

4.2 Composition and balance of the board

A feature of many corporate governance scandals has been boards that are dominated by a **single senior executive** with other board members merely acting as a rubber stamp. Sometimes the single individual may bypass the board to further his own interests. Even if an organisation is not dominated by a single individual, there may be other weaknesses in board composition.

The organisation may be run by a small group centred round the chief executive and chief financial officer, where appointments may be made by personal recommendation rather than a formal, objective process.

Hong Kong is quite unique in some respects in that family-owned enterprises compose the major part of the region's businesses. This poses challenges for the composition and balance of the board, as family members tend to dominate. A 2001 study by the OECD indicated that around 80% of listed companies in Hong Kong are controlled by family members.

4.2.1 Independent Non-Executive Directors [INEDs] required to form one-third of board

One of the new rules from the Consultation paper (see Chapter 2, section 2) is that at least one-third of an issuer's board should be independent non-executive directors (**INEDs**). Listed companies must comply with the rule **by 31 December 2012**. Also the Exchange has introduced a rule which allows an issuer a three-month period to appoint a sufficient number of INEDs to comply with the one-third rule if it has previously failed to meet the requirement.

4.3 Reliability of financial reporting and external auditors

Issues concerning **financial reporting and auditing** are seen by many investors as crucial because of their central importance in ensuring management accountability. They have therefore been the focus of much debate and litigation. While focusing the corporate governance debate solely on accounting and reporting issues is inadequate, the greater regulation of practices such as off-balance sheet financing has led to **greater transparency** and a **reduction in risks** faced by investors.

External auditors may not carry out the necessary questioning of senior management because of fears of **losing the audit**, and internal auditors do not ask awkward questions because the chief financial officer **determines their employment prospects**. Often corporate collapses are followed by criticisms of external auditors, where poorly planned audit work failed to identify illegal use of client monies.

4.4 Directors' remuneration and rewards

Directors being paid excessive salaries and bonuses has been seen as one of the major corporate abuses for a large number of years. It was therefore inevitable that the corporate governance codes have targeted this issue.

4.5 Responsibility of the board for risk management and internal control systems

Boards that meet irregularly or fail to consider systematically the organisation's activities and risks are clearly not fulfilling their responsibilities. Sometimes the failure to carry out proper oversight is due to a **lack of information** being provided, which in turn may be due to inadequate systems being in place for the **measurement** and **reporting of risk**.

4.6 Rights and responsibilities of shareholders

It is important to know shareholders' rights and the role of shareholders, particularly institutional shareholders and it has been the subject of much debate. Shareholders should have the right to

receive all **material information** that may affect the value of their investment and to **vote** on measures affecting the organisation's **governance**.

Commencing on 1 April 2012, under the new Code Provisions an issuer must disclose the following “shareholder rights” information in its Corporate Governance Report:

- The way in which shareholders can convene an extraordinary general meeting;
- The procedures for sending enquiries to the board (with sufficient contact details); and
- The procedures for making proposals at shareholders’ meetings (with sufficient contact details).

Previously it was a recommendation only that this information should be disclosed.

4.7 Corporate social responsibility and business ethics

The lack of consensus about the issues for which businesses are responsible and the stakeholders to whom they are responsible has inevitably made corporate social responsibility and business ethics an important part of the corporate governance debate.

The relationship between a company and its stakeholders should be mutually beneficial and this is the way to create sustained business success and steady long-term growth in corporate value.

4.8 Public and non-governmental bodies' corporate governance

Many of the principles that apply to company corporate governance also apply to government bodies or other major entities such as charities. Boards will be required to act with **integrity**, to **supervise the body's activities properly** and to **ensure appropriate control and risk management and reporting systems** are being maintained.

However, there are certain ways in which companies might differ from other types of organisation, such as in their ownership (principals), lack of competition and their legal/regulatory environment within which they operate.

4.8.1 Composition of boards

This may be determined by regulation or may be tailored by the body's constitution. There may be more than one board; possibly an **executive board** for overseeing operations, and a **stakeholder board** containing representatives of all major stakeholder groups, which determines objectives and ensures stakeholder interests are being represented.

4.8.2 Conduct of directors

Directors may be subject to **organisation or sector-specific** controls to ensure that they act in the public interest.

4.8.3 Compulsory regulations versus voluntary best practice

Certain guidelines that are voluntary best practice in the corporate sector may be compulsory for some other sorts of organisation, for example maintenance of an internal audit department.

4.8.4 Disclosure of internal control

Certain types of organisations are required to make disclosures about specific controls such as risk registers, training, key performance indicators and reporting systems. Regulations such as the Sarbanes Oxley Act 2002, section 404: Assessment of Internal Controls, have made this a mandatory disclosure requirement in certain jurisdictions, such as the USA.

4.9 The driving forces underlying the governance code development

Corporate governance issues came to prominence in the USA during the 1970s and in the UK and Europe from late 1980s. The main, but not the only, drivers associated with the increasing demand for the development of governance were as follows:

- (a) **Increasing internationalisation and globalisation** meant that investors, and institutional investors in particular, began to invest outside their home countries. The King report in South Africa (1994 and revised in 2002) highlights the role of the free movement of capital, commenting that investors are promoting governance in their own self-interest.
- (b) The **differential treatment of domestic and foreign investors**, (both in terms of reporting and associated rights/dividends) and the excessive influence of majority shareholders in insider jurisdictions, caused many investors to call for parity of treatment.
- (c) Issues concerning **financial reporting** were raised by many investors and were the focus of considerable debate and litigation. Shareholder confidence in what was being reported in many instances was eroded. While corporate governance development isn't just about better financial reporting requirements, the regulation of practices such as off-balance sheet financing has led to greater transparency and a reduction in risks faced by investors.
- (d) The characteristics of individual countries may have a **significant influence** in the way corporate governance has developed. The King report in South Africa (1994 and revised in 2002) emphasises the importance of qualities that are fundamental to the South African culture such as collectiveness, consensus, helpfulness, fairness, consultation and religious faith in the development of best practice.
- (e) An increasing number of **high profile corporate scandals** and collapses including Maxwell Communications Corporation (refer to the case study below) and the Enron scandal prompted the development of governance codes. However, the scandals since then have raised questions about further measures that may be necessary.



Case study

Robert Maxwell was a Czech refugee who came to the UK in 1940. He served in the British Army and was awarded the Military Cross. After the war, he built up a massive publishing empire that included at various times the Pergamon Press, Mirror Group Newspapers, the Berlitz language guides and the New York Daily News. He was a famous celebrity, well-known to millions as a flamboyant Member of Parliament and was heavily involved in professional football as the owner of Oxford United Football Club and a director of Derby County Football Club.

Maxwell's success meant that at its peak Maxwell Communications plc was one of the largest publicly quoted companies in the UK.

Like many publishing companies it was necessary to borrow to lever future growth. Maxwell appeared to have no difficulty in financing his businesses. Although over time there were many rumours about his business affairs, he adopted a highly litigious approach to his critics and took several successful libel actions against popular magazines.

As it happened, Maxwell borrowed significant funds from the pensions funds run on behalf of his companies' employees. Although this practice is subject to rigorous controls today, it was both unregulated and quite common practice in the 1980s. In the same period he bought and sold companies frequently in order to disguise the true financial position of his businesses.

In 1991 it was reported that Maxwell's companies were not meeting the statutory reporting requirements in respect of the pension schemes. Members of these schemes made complaints in both the UK and the USA. Maxwell's situation was worsened by the fact that he had used his shares in his own companies to secure long-term borrowings. When the creditors sold these shares it caused their prices to fall in the market. Maxwell responded by using borrowed funds, including some of the operating balances of his companies and pension funds, to purchase shares in order to support the share price.

Maxwell died by drowning in 1991. The official verdict was accidental death, though inevitably there have been numerous conspiracy theories surrounding the accident even since. As is often the case, the true situation concerning his businesses did not emerge immediately. It transpired that he had used many millions of pounds belonging to occupational pension schemes to support his businesses. Many employees lost their pensions as a result.

In 1995 several directors of Maxwell companies, including his two sons, were tried for fraud but were acquitted.

The Maxwell scandal and the resultant consequences led to the enactment of stringent new legislation imposing strict controls on pension funds and their relationships with employers contributing to the schemes.

4.10 Development of corporate governance codes

To combat these problems codes of best practice were developed in many jurisdictions. Some of the main provisions of codes have been clear attempts to deal with difficult situations. The problem of an overbearing individual dominating a company has been countered by recommendations in many codes that different directors occupy the positions of a company of chief executive officer and chairman at the head of a company.

The development of codes has been also prompted by the need to clarify ambiguities in the law, or require a higher standard of behaviour than local legislation requires. Codes have also been developed to ensure local companies comply with international best practice.

5 Corporate social responsibility



Topic highlights

Debates on organisations' **social responsibilities** focus on what these responsibilities are, how organisations should deal with stakeholders and what aspects of an organisation's environment, policies and governance are affected.

5.1 Significance of corporate social responsibility

Businesses, particularly large and high profile ones, are subject to increasing expectations that they will exercise corporate social responsibility.

5.1.1 Economic responsibilities

Companies have economic responsibilities to shareholders demanding a good return, to employees wanting fair employment conditions and customers who are seeking good-quality products at a fair price. Businesses are set up to be properly functioning economic units and so this responsibility forms the basis of all others.

5.1.2 Legal responsibilities

Since laws **codify society's moral views**, obeying those laws must be the foundation of compliance with social responsibilities. Although in all societies corporations will have a minimum of legal responsibilities, there is perhaps more emphasis on them in some European economies where the focus of discussion has been whether many legal responsibilities constitute excessive red tape.

5.1.3 Ethical responsibilities

These are responsibilities that require corporations to act in a **fair and just way** even if the law does not compel them to do so.

5.1.4 Philanthropic responsibilities

These are **desired** rather than being required of companies. They include charitable donations, contributions to local communities and providing employees with the chances to improve their own lives.

5.2 Corporate social responsibility and stakeholders

Inevitably discussion on corporate social responsibilities has been tied in with the stakeholder view of corporate activity, the view that since businesses benefit from the goodwill and other tangible aspects of society, they therefore owe society **certain duties** in return, particularly towards those affected by its activities.

5.2.1 Problems of dealing with stakeholders

Whatever the organisation's view of its stakeholders, certain problems in dealing with them on corporate social responsibility may have to be addressed.

- (a) Collaborating with stakeholders may be **time-consuming** and **expensive**;
- (b) There may be **culture clashes** between the company and certain groups of stakeholders, or between the values of different groups of stakeholders with companies caught in the middle;
- (c) There may be **conflict between company and stakeholders** on certain issues when they are trying to collaborate on other issues;
- (d) **Consensus** between different groups of stakeholders may be difficult or impossible to achieve, and the solution may not be economically or strategically desirable;
- (e) Influential stakeholders' **independence** (and hence ability to provide necessary criticism) may be compromised if they become too closely involved with companies; and
- (f) Dealing with certain stakeholders (eg public sector organisations) may be complicated by their being **accountable in turn to the wider public**.

5.3 Impact of corporate social responsibility on strategy and corporate governance

Social responsibilities can impact on what companies do in a number of ways.

5.3.1 Objectives and mission statements

If the organisation publishes a mission statement to inform stakeholders of strategic objectives, **mention of social objectives** is a sign that the board believes that they have a significant impact on strategy.

5.3.2 Ethical codes of conduct

As part of their guidance to promote **good corporate behaviour** among their employees, some organisations publish a **business code of ethics**.

5.3.3 Corporate social reporting and social financial statements

Some organisations, as part of their reporting on operational and financial matters, report on **ethical or social conduct**. Some go further, **producing social financial statements** showing quantified impacts on each of the organisation's stakeholder constituencies.

5.3.4 Corporate governance

Impacts on corporate governance could include representatives from key stakeholder groups on the board, or perhaps even a **stakeholder board of directors**. It also implies the need for a binding corporate governance code that regulates the rights of stakeholder groups.

5.4 Ownership and corporate social responsibility

Having raised the issue of the social responsibilities of companies, we also need to consider the responsibilities of shareholders in companies. One view is that shareholders, by buying shares in a company in the hope of greater returns, buy a responsibility; they should be insisting that those managing the company carry out a policy that is consistent with the **public welfare**.

One of the main problems with this view in relation to large corporations is the **wide dispersion of shareholders**. This means that shareholders with small percentage holdings have negligible influence on managers. In addition, the ease with which shareholders can **dispose of shares** on the stock markets arguably loosens their feeling of obligation in relation to their property. This then raises the question of why the speculative (and possibly short-term) interests of shareholders should prevail over the longer-term interests of other stakeholders.

In corporate governance discussions, the idea of ownership responsibilities have had a significant influence because of the importance of **institutional shareholders**. Not only do they have the level of shareholdings that can be used as a lever to pressure managers, but they themselves have **fiduciary responsibilities** as trustees on behalf of their investors.



Self-test question 2

Omnipower is an energy producer selling electricity and gas to private and business consumers. It is a newly-established company, owned by a consortium of energy companies from different countries.

The production of energy is a topical and controversial issue in the country in which Omnipower operates. The country is very beautiful and rich in natural resources, so tourism is vital to the national economy. The inhabitants of the country are fiercely protective of the environment and their quality of life.

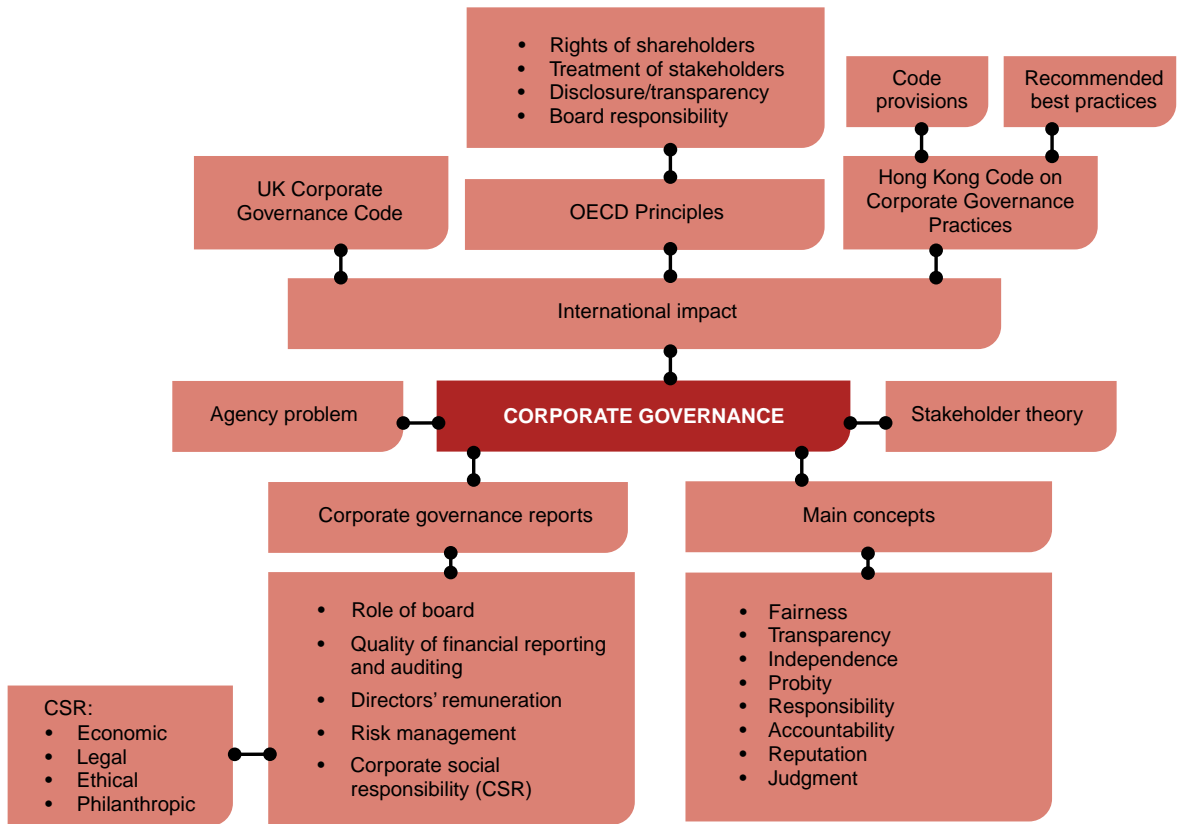
Anxious to build a positive relationship with the communities in which it will operate, Omnipower has decided to produce a corporate social responsibility statement that will guarantee certain principles to which it will adhere.

Greenspace, a local environmental pressure group, has already resisted the entry of new energy companies to the country and has pledged that it will relentlessly pressurise Omnipower to adopt environmentally friendly policies.

- (a) Identify the stakeholders in relation to Omnipower. Compare and contrast their respective needs.
- (b) Set out the matters that should be included in Omnipower's corporate social responsibility (CSR) statement, including details of commitments that the company should make to its stakeholders.

(The answer is at the end of the chapter)

Topic recap



Answers to self-test questions

Answer 1

- (a) The **OECD Framework** proposes that corporate governance be considered in relation to five areas:

Rights of shareholders

The corporate governance framework should protect shareholders and facilitate their rights in the company. Companies are obliged to generate investment returns for the risk capital put up by the shareholders. Directors should be accountable to shareholders in this respect.

Equitable treatment of shareholders

All shareholders should be treated equitably (fairly), including those who constitute a minority, individuals and foreign shareholders. Shareholders should have redress when their rights are contravened or where an individual shareholder or group of shareholders is oppressed by the majority.

Stakeholders

The corporate governance framework should recognise the legal rights of stakeholders. The company should facilitate co-operation with stakeholders in order to create wealth, employment and sustainable enterprises.

Disclosure and transparency

Companies should make relevant and timely disclosures on matters affecting financial performance, management and ownership of the business.

Board of directors

The board of directors is responsible for setting the direction of the company and monitoring the management of the company in order to achieve its stated objectives. The corporate governance framework should underpin the board's accountability to the company and its members.

- (b) The term “probity” relates to honesty but goes further than simply telling the truth. Being dishonest implies telling lies. A lack of probity, on the other hand, is not giving the true picture of a situation, or acting in a manner that is misleading to others.

For example, giving raw data or incomplete financial information that may lead to inaccurate conclusions demonstrates a lack of probity.

The term has been used by several judges in cases of wrongful trading. Often, a business person may not intend to defraud creditors but may present an over-optimistic view of the business based on a belief that its fortunes can be turned around.

Answer 2

- (a) The stakeholders in this situation are:

- customers of Omnipower
- owners of Omnipower
- the community and the local environment
- residents who are not customers
- the government
- Greenspace (whose members may also be customers, residents or both)
- employees of Omnipower

Using a table for simple presentation:

Stakeholder category	Needs
Customers	Low prices and good quality service.
Owners of Omnipower	Capital growth and dividends. Payback on investment.
Community and environment	No adverse effects on landscape. No depletion of natural resources if avoidable. Development of new sources of renewable energy. As little pollution as possible.
Residents who are not customers	Same as community.
Government	Compliance with laws. Operations to be consistent with environmental policy.
Greenspace	Same as community and environment.
Employees	Stable salary, job satisfaction and future employment development.

It can be seen from the table that the needs polarise into two sets of stakeholders. The first set wants the company to be efficient and deliver energy as cost-effectively as possible. A secondary concern here might be environmental impact. The second set are more concerned with the impact on the environment as a primary need.

Energy companies are in an almost impossible position in relation to reconciling the needs of stakeholders when there is polarisation of views.

- (b) A CSR statement should address all major concerns in relation to social responsibilities. In the case of Omnipower, it should address both social and environmental concerns.

One example of CSR policy is the stakeholder analysis that forms the basis of CSR in Scottish Power, a UK-based energy company. It defines accountabilities in relation to:

- provision of energy (the primary economic aim)
- health and safety
- customer experience (satisfaction)
- climate change and emissions
- waste and resource usage
- biodiversity
- sites, siting and infrastructure
- employees
- customers with special circumstances
- community
- procurement
- economic

It will be apparent from the above list that most of the concerns of the stakeholders of Omnipower fall into one or more categories.

Exam practice



Corporate governance

16 minutes

Trading & Factory Limited (“T&F”) has been producing and selling outdoor furniture and garden ornaments to North America for about ten years. T&F’s founder, Mr. Lee, has occupied the roles of Chairman and Chief Executive Officer for three years, and has largely dominated its board of directors.

T&F struggled financially during 20X8-X9, but it has managed to survive through the recession and has recently presented the unaudited management accounts for the year ended 31 December 20Y0 to its auditor. Extracted below are certain key financials for the years 20X9 and 20Y0.

	Extracts from unaudited management accounts for the year ended 31 December 20Y0	Extracts from audited financial statements for the year ended 31 December 20X9
	HK\$'000	HK\$'000
Sales	482,100	254,300
Gross margin	30%	29%
Net profit before tax	98,100	16,200
Current ratio	0.9	1.2

Following the recent revival in performance, Mr. Lee has expressed T&F’s desire to go for a listing within a year or two.

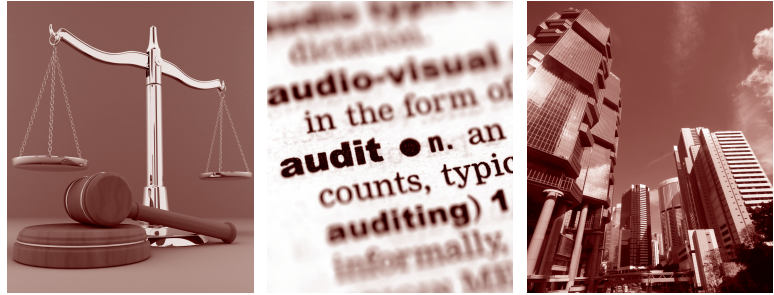
Due to the lack of financial expertise on the board and without a separate audit committee, T&F’s board has been relying on the management letter from its auditor to monitor the operating effectiveness of its internal controls.

Required

Make three recommendations to improve T&F’s corporate governance.

(9 marks)

HKICPA June 2011 (amended)



chapter 2

Corporate governance reports and practice

Topic list

- | | |
|---|---|
| <p>1 Significance of international codes</p> <p>1.1 Limitations of international codes</p> <p>2 Code on Corporate Governance Practices in Hong Kong and the UK Corporate Governance Code</p> <p>2.1 Code on Corporate Governance Practices in Hong Kong and the UK Corporate Governance Code</p> <p>3 Corporate governance developments in Hong Kong</p> <p>3.1 Similarities between the Code in Hong Kong and the UK Corporate Governance Code</p> <p>3.2 Comply or explain approach (principles-based approach)</p> <p>3.3 Application of principles-based approaches by investors</p> <p>3.4 Current issues</p> <p>3.5 Structure of the Code in Hong Kong</p> <p>3.6 Corporate Governance Report (CGR) in Hong Kong</p> | <p>4 Board committees</p> <p>4.1 Audit committees</p> <p>4.2 Nomination committee</p> <p>4.3 Remuneration committee</p> <p>5 Management's responsibilities to comply with corporate governance requirements</p> <p>5.1 Duties of directors</p> <p>5.2 Composition and balance of the board</p> <p>5.3 Reliability of financial reporting and external auditors</p> <p>5.4 Directors' remuneration and rewards</p> |
|---|---|

Learning focus

You may well have to discuss the implications of basing governance guidance on principles. Knowledge of the main features and advantages and disadvantages of corporate governance codes in general is important, but line-by-line knowledge is not required. Questions normally require assessment of the strength of corporate governance arrangements in a particular organisation.

As regards specific codes, the main themes of Sarbanes-Oxley may be tested. The UK Corporate Governance Code (formerly known as the Combined Code) sets out good practice but students should be aware of Hong Kong local codes of practice.

The existence of wider social responsibilities is likely to be a theme in questions.

Learning outcome

In this chapter you will cover the following learning outcomes:

		Competency level
3.01	Background to corporate governance developments	2
3.01.03	Explain corporate governance developments in Hong Kong and the structure of the Code on Corporate Governance Practices and Corporate Governance Report in Hong Kong	
3.02	Key issues relating to corporate governance including directors' remuneration, board composition, audit committee and non-controlling interests	2
3.02.02	Describe the corporate governance requirements as set out in the Companies Ordinance and Hong Kong Stock Exchange Listings Requirements relating to directors' responsibilities (for example, risk management and internal control) and the reporting responsibilities of auditors	
3.03	Management's responsibilities to comply with corporate governance requirements and to implement related practices	3
3.03.01	Explain the responsibilities of management within the corporate governance framework	
3.03.02	Analyse the structure and roles of board committees and discuss their drawbacks and limitations	
3.04	Auditor's responsibilities to consider and address corporate governance requirements	3
3.04.01	Explain the auditor's responsibility to consider and address corporate governance requirements	

1 Significance of international codes



Topic highlights

Codes such as the OECD Code mentioned in the previous chapter have been developed from best practice in a number of jurisdictions. As such, they can be seen as **representing an international consensus**. They stress global issues that are important to companies operating in a number of jurisdictions. The OECD Code for example, emphasises the importance of **eliminating impediments to cross-border shareholdings** and **treating overseas shareholders fairly**.

Although the OECD Code (mentioned in Chapter 1) is **non-binding and voluntary**, its principles have been incorporated into national guidance by a number of countries. The OECD Principles have also been used by world-wide organisations as a basis for assessing the corporate governance frameworks and practices in individual countries. These assessments are used to determine the level of policy dialogue with, and technical assistance given to, these countries.

The fact that the local codes of different countries are based on the same international code means that **compliance costs for companies** who are **operating in many jurisdictions** will be reduced. It also gives investors **some confidence** about the application of governance rules.

The development of international codes should also be seen in the context of the **development of robust financial reporting rules**, since investors' concerns with unreliable accounting information has meant that they have questioned corporate governance arrangements. Developments in international accounting standards aim to **promote greater international harmony in accounting practice**, and international convergence on corporate governance is consistent with this.

1.1 Limitations of international codes

A number of problems have been identified with international codes.

- (a) International principles represent a **lowest common denominator** of general, fairly bland, principles.
- (b) Any attempt to strengthen the principles will be extremely difficult because of **global differences** in legal structures, financial systems, structures of corporate ownership, culture and economic factors.
- (c) As international guidance has to be based on **best practice** in a number of regimes, development will always lag behind changes in the most advanced regimes.
- (d) The codes have **no legislative power**.
- (e) The costs of following a very structured international regime (such as one based on **Sarbanes-Oxley**) may be **very burdensome** for **companies based in less developed countries** that are not used to such regulation.

2 Code on Corporate Governance Practices in Hong Kong and the UK Corporate Governance Code

2.1 Code on Corporate Governance Practices in Hong Kong and the UK Corporate Governance Code



Topic highlights

The Hong Kong Stock Exchange published the Code on Corporate Governance Practices (the HK Code) and the Corporate Governance Report (CGR) in November 2004, which is included into the Appendix (Appendix 14) of the Main Board Listing Rules and the Growth Enterprise Market (GEM) Listing Rules. The HK Code and CGR became effective in 2005.

A range of code provisions (“CP”), recommended best practices (“RBP”) and rules have been amended. Most of the rule amendments will be effective on 1 January 2012 whilst other Code amendments will be effective on 1 April 2012.

Listed companies are required to confirm their compliance with the HK Code or, where they do not comply, to provide explanations for any variation in practice.

The HK Code is broken down into six main areas which will be examined later in this chapter:

- 1 Directors
- 2 Remuneration of Directors and Senior Management and Board Evaluation
- 3 Accountability and Audit
- 4 Delegation by the Board
- 5 Communication with Shareholders
- 6 Company Secretary

The **UK Corporate Governance Code** (formally known as the Combined Code) similarly contains detailed guidance on good corporate governance, and strongly influences the corporate governance requirements in other jurisdictions around the world including Hong Kong.

2.1.1 A history of corporate governance

Before we discuss the provisions of the HK Code, there is a history of corporate governance in other countries, especially in the UK, that affects Hong Kong companies.

As a result of several accounting scandals in the 1980s and 1990s, the **Cadbury Code** in the UK was the first code of corporate governance produced, for UK listed companies. Subsequently, in 1995, the **Greenbury report** added a set of principles on the remuneration of executive directors for UK listed companies. The **Hampel report** in 1998 brought the Cadbury and Greenbury reports together to form the first Combined Code, adding requirements relating to internal control and risk management. In 1999, **Turnbull** produced a report explaining how the risk management and internal control requirements should be applied.

In 2002, the **Higgs report** (*Review of the role and effectiveness of non-executive directors*) and the **Smith report** on the role of audit committees were produced, and a new Combined Code was issued.

In 2010, a new **Stewardship Code** for investment institutions was issued by the Financial Reporting Council, providing guidelines on the role of investment institutions (as shareholders of listed companies) in promoting good corporate governance practices. The Combined Code was also revised in 2010 and renamed as the **UK Corporate Governance Code**. The amendments included a clearer statement of the board’s responsibilities relating to risk, a greater emphasis on the importance of getting the right mix of skills and experience on the board, and recommendation that all directors of FTSE 350 companies be put up for re-election every year. The Code was revised again in 2012.

The development of corporate governance in Hong Kong is considered below.

1998

The Hong Kong Stock Exchange issued its **guidance** of the Code of Best Practice for the Hong Kong listed companies in 1998, to form the skeleton of a code of best practice to which listed companies in Hong Kong should aim to adhere. Companies listed on the Main Board were required to **devise their own codes of practice** in the interest of both non-executive directors and the board of directors as a whole. Whereas, for companies listed on the Exchange's Growth Enterprise Market (GEM) Board, the company had to **establish an audit committee** with at least three independent non-executive directors and should appoint competent personnel for some specified management positions.

2004 – 2005

In 2004, the Hong Kong Stock Exchange issued its draft Code on Corporate Governance Practices (**the Code**) and the associated Corporate Governance Report (**CGR**) to help to strengthen the overall standard of corporate governance of Hong Kong issuers. The revised Code on corporate governance provides a **detailed approach** to various areas of corporate governance in Hong Kong. The HK Code replaces the previous Listing Rules (**the Code of Best Practice**) related to corporate governance whilst the Rules on the Corporate Governance Report set out the requirements in respect of the preparation and issuance of a Corporate Governance Report (CGR). The new rules require the board of directors to prepare an additional report (CGR), for inclusion in the annual report.

The HK Code and the CGR have considered the principles and guidelines set out in the revised UK Corporate Governance Code and the proposals set by the Standing Committee on Company Law Reform in June 2003.

The HK Code and the Rules on the CGR were effective for accounting periods commencing on or after 1 January 2005. The Hong Kong Stock Exchange has issued the HK Code and the CGR as Appendices to the Listing Rules for Main Board issuers and GEM issuers.

As mentioned in Chapter 1, the HKICPA Corporate Governance Committee (the CG Committee) has issued several publications on corporate governance such as *Corporate Governance for Public Bodies – A Basic Framework* in 2004 and *Internal Control and Risk Management – A Basic Framework* in 2005 respectively.

2007 – 2009

In February 2009 the Hong Kong Stock Exchange issued its major findings of the third annual review (2007) of listed issuers' compliance with the Code (the Third Review).

To develop or enhance an in-house code, the Hong Kong Institute of Certified Public Accountants, The Hong Kong Institute of Directors, the Hong Kong Stock Exchange and the Hong Kong Ethics Development Centre, Independent Commission Against Corruption (ICAC) sought permission from the International Federation of Accountants (IFAC) to reproduce "The International Good Practice Guide, entitled *Defining and Developing an Effective Code of Conduct for Organisations*", in Hong Kong. (We have already discussed the key principles of this guidance in Chapter 1.)

2010 – 2012

Following the financial crisis outbreak in late 2008, the Hong Kong Stock Exchange published a consultation paper on proposed changes to the HK Code and certain Listing Rules to corporate governance to enhance the corporate governance in Hong Kong in December 2010. The consultation period ended in March 2011 where the Hong Kong Stock Exchange adopted most of the proposals outlined in the Consultation Paper, subject to certain modifications as set out in the Consultation Conclusions.

The amendments will keep the Corporate Governance Code in line with international best practices. In its first interim/half year or annual report covering a period after 1 April 2012, the issuer must state, in that report, whether it has, for that period, complied with the Code Provisions (CPs) in the revised Code as well as those of the former Code. Issuers may adopt the revised Code at an earlier date than 1 April 2012.

HKEx's Consultation on Board Diversity

On 7 September 2012, Hong Kong Exchanges and Clearing Limited (the "HKEx") published its "Consultation Paper – Board Diversity" (the Consultation Paper) to set out the proposed amendments concerning board diversity to Appendix 14 (Corporate Governance Code (the Code) and Corporate Governance Report) to the Rules Governing the Listing of Securities on the Hong Kong Stock Exchange.

The major purposes of the proposed amendments are to promote effective decision-making and better governance, and monitoring through diversity in the boardroom. It is proposed that diversity will be given a wide interpretation and no criteria will be prescribed to define its meaning. An issuer should take into account various factors to achieve boardroom diversity depending on its own business model and circumstances, including gender, age, cultural and educational background and professional experience.

On 13 December 2012, the HKEx published **consultation conclusions** on board diversity.

Having received broad support to promote board diversity within listed issuers, the HKEx has decided to implement new measures. In brief, the measures include a Code Provision ("CP") which requires the issuer to:

- have a Board Diversity policy
- disclose the policy or its summary in the issuer's corporate governance report, and
- disclose any measurable objectives for implementing the policy and progress on achieving those objectives.

In addition, a note is added under the CP to clarify how the HKEx intends diversity to be understood. The measures will be effective on 1 September 2013. The conclusions are as follow:

(i) **Board composition**

The board should have a **balance of skills, experience and diversity** of perspectives appropriate to the requirements of the issuer's business. It should ensure that changes to its composition can be managed without undue disruption. It should include a balanced composition of executive and non-executive directors (including independent non-executive directors) so that there is a strong independent element on the board, which can effectively exercise independent judgment. Non-executive directors should be of sufficient calibre and number for their views to carry weight.

(ii) **Appointments, re-election and removal**

There should be a **formal, considered and transparent procedure** for the appointment of new directors. There should be plans in place for orderly succession for appointments. All directors should be subject to re-election at regular intervals. An issuer must explain the reasons for the resignation or removal of any director.

(iii) **Nomination Committee**

The nomination committee (or the board) should have a policy concerning diversity of board members, and should disclose the policy or a summary of the policy in the corporate governance report which is included in the annual report.

Board diversity will differ according to the circumstances of each issuer.

Diversity of board members can be achieved through consideration of a number of factors, including but **not limited** to gender, age, cultural and educational background, or professional experience. Each issuer should take into account its own business model and specific needs, and disclose the rationale for the factors it uses for this purpose.

2.1.2 Principles of the HK Code and the UK Corporate Governance Code

The HK Code lays down standards of good practice for entities on issues such as the composition of the board, directors' remuneration, accountability and audit, relations with shareholders communication with shareholders and the role of company secretary.

The HK Code contains a combination of:

- broad principles
- more specific provisions (Code provisions (CP) and
- recommended best practices (RBPs).

Companies are required to conduct their corporate governance in accordance with the principles and to apply the detailed code provisions. They are also encouraged to follow recommended best practices.

The Listing Rules (Chapter 3) apply a “**comply or explain**” approach, and listed companies in HK have to disclose that they have applied the code provisions, or if they have not, to provide an explanation why.

The HK Code refers to companies as “issuers”. The main principles of the Code are set out below.

The major principles of the HK Code

Section A: Directors

The Board

An issuer should be headed by an effective board, which should assume responsibility for leadership and control of the issuer, and be collectively responsible for promoting the success of the issuer by directing and supervising the issuer's affairs. Directors should take decisions objectively and in the interests of the issuer.

Directors' duties

The rule emphasises directors' duties as it requires directors to take an active interest in the issuer's affairs, to obtain a general understanding of its business and follow up any relevant matters that come to their attention. The directors are required to apply the required levels of skill, care and diligence as failure to discharge their duties and responsibilities may result in disciplinary action by the Hong Kong Stock Exchange and may attract civil and/or criminal liabilities. The rule was implemented commencing on 1 January 2012.

Chairman and Chief Executive Officer

There are two key aspects of the management of every issuer – the management of the board, and the day-to-day management of the issuer's business. There should be a clear division of these responsibilities at the board level so that power is not concentrated in any one individual.

The new CP places greater emphasis on the roles and responsibilities of the chairman. The CP was implemented commencing on 1 April 2012.

Board composition

The board should have a balance of skills and experience appropriate for the requirements of the business of the issuer. The board should ensure that changes to its composition can be managed without undue disruption.

The new rule requires that at least one-third of an issuer's board should be independent non-executive directors (**INEDs**). Listed companies must comply with the rule **by 31 December 2012**. Companies which do not satisfy this rule have a three-month period to appoint a sufficient number of INEDs.

Appointments, re-election and removal

There should be a formal, considered and transparent procedure for the appointment of new directors to the board. There should be plans in place for orderly succession for appointments to the board. All directors should be subject to re-election at regular intervals. An issuer must explain the reasons for the resignation or removal of any director.

Notifying directorship change and disclosure of directors' information (including the chief executive)

The amended rule requires issuers to:

- disclose information on the retirement or removal of a director or supervisor;
- disclose information on the appointment, resignation, re-designation, retirement or removal of a chief executive;
- disclose director's information on all civil judgments of fraud, breach of duty, or other misconduct involving dishonesty; and
- clarify that the sanctions referred to in rule 13.51B(3)(c) are those made against the issuer.

The RBP has been upgraded to a CP stating that a list of directors should be published on the issuer's website and added that it should also be published on the HKEx website.

(Implementation date: 1 January 2012)

An INED who has served nine years

The previous RBP has been upgraded to CP. This states that it recommends that shareholders should vote on a separate resolution to retain an INED who has served on the board for more than nine years. Listed companies should include the reasons why the board considers the INED independent in the circular nominating him for election.

(Implementation date: 1 April 2012)

Directors' training

The Hong Kong Stock Exchange has upgraded a RBP to a CP on directors' training. According to the new CP, directors should provide issuers with records of training they have received.

Listed companies must disclose in their Corporate Governance Reports how directors have complied with the CP on training.

(Implementation date: 1 April 2012)

Responsibilities of directors

Every director is required to keep abreast of his responsibilities as a director of an issuer and of the conduct, business activities and development of that issuer. Given the essential unitary nature of the board, non-executive directors have the same duties (of care and skill, and fiduciary duties) as executive directors.

The new CP states that the board should regularly review the contribution made by a director and the performance of his responsibilities including whether he is spending sufficient time performing them. Under the new CP, the directors should inform the issuer of any change in their significant commitments. This information should be provided in a timely manner.

(Implementation date: 1 April 2012)

Supply of and access to information

Directors should be provided in a timely manner with appropriate information, in such form and of such quality as will enable them to make an informed decision and to discharge their duties and responsibilities as directors of an issuer.

The new CP states that management should provide monthly updates to board members giving a balanced and understandable assessment of the issuer's performance, position and prospects in sufficient detail to enable them to discharge their duties. This information may include information such as monthly management accounts and management updates.

(Implementation date: 1 April 2012)

Corporate governance functions

The new CP states that the board should be responsible for corporate governance and in addition, says that an issuer should establish terms of reference on duties that should be performed by the board or committees delegated by the board.

A new rule has also been introduced which requires issuers to disclose the corporate governance policy and duties performed in the Corporate Governance Report.

(Implementation date: 1 April 2012)

Board evaluation

An RBP has been introduced recommending that the board conducts a regular evaluation of its performance.

(Implementation date: 1 April 2012)

Directors' insurance

The RBP had been upgraded requiring that an issuer should arrange appropriate insurance coverage for directors.

Directors' attendance at board meetings

The new CP states that non-executive directors, including INEDs, should attend board, committee and general meetings and contribute to the issuer's strategy and policies.

The new requirement also states that issuers must disclose details of the attendance at general meetings of each director by name in its Corporate Governance Report.

Further, it should disclose the attendance at the AGM of the chairman of the board and the chairmen of the audit, remuneration and nomination committees and other chairmen of "any other committee".

The new CP clarifies that, subject to the issuer's constitutional documents and the laws and regulations of its place of incorporation, it may count directors' attendance by electronic means (including telephonic or video-conferencing) as attendance at a physical board meeting.

(Implementation date: 1 January 2012)

A new rule which should be implemented from 1 April 2012 removes the 5 per cent threshold for voting on a resolution in which a director has an interest.

Section B: Remuneration of directors and senior management and board evaluation

The level and make-up of remuneration and disclosure

An issuer should disclose information relating to its directors' remuneration policy and other remuneration related matters. There should be a formal and transparent procedure for setting policy on executive directors' remuneration, and for fixing the remuneration packages for all directors. Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, but companies should avoid paying more than is necessary for this purpose. No director should be involved in deciding his own remuneration.

Notes

- 1 Under paragraph 24 of Appendix 16, directors' fees and any other reimbursement or emolument payable to a director must be disclosed in full in the annual reports and accounts of the issuer on an individual and named basis.
- 2 Under paragraph 24B of Appendix 16 of the Listing Rules, issuers are required to give a general description of the emolument policy and long-term incentive schemes of the group as well as the basis of determining the emolument payable to their directors.

Disclosure of senior management remuneration by band

A new CP states that senior management remuneration should be disclosed by band.

(Implementation date: 1 April 2012)

Disclosure of chief executive's remuneration

Issuers are required to disclose the remuneration of a chief executive who is not a director.

(Implementation date: 1 January 2012)

Section C: Accountability and audit

Financial reporting

The board should present a balanced, clear and comprehensible assessment of the company's performance, position and prospects.

Internal controls

The board should ensure that the issuer maintains sound and effective internal controls to safeguard the shareholders' investment and the issuer's assets.

(Note. The objectives of the internal controls are:

- To ensure achievements of the company's objectives, including its stated goals and business targets in an effective and efficient manner
- To ensure economical and effective use of resources and adequately safeguard the Group's assets against unauthorised use or disposition
- To ensure maintenance of proper records for providing reliable financial, managerial and operating information for decision-making, evaluation of activities or publication
- To ensure adequate control of the risks inherent in operations
- To ensure compliance with applicable legislation and regulations.)

Audit committee

The board should establish formal and transparent arrangements for considering how it will apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. The audit committee established by an issuer pursuant to the Hong Kong Stock Exchange Listing Rules should have clear terms of reference.

Section D: Delegation by the board

Management functions

An issuer should have a formal schedule of matters specifically reserved to the board for its decision. The board should give clear directions to management as to the matters that must be approved by the board before decisions are made on behalf of the issuer.

Board committees

Board committees should be formed with specific written terms of reference which deal clearly with the committees' authority and duties.

Section E: Communication with shareholders

Effective communication

The board should endeavour to maintain an on-going dialogue with shareholders and in particular, use annual general meetings or other general meetings to communicate with shareholders and encourage their participation.

A new CP states that issuers should establish a shareholder communication policy.

Issuers should also avoid “bundling” resolutions and, where they are “bundled”, issuers are required to explain the reasons and material implications in the notice of meeting.

(Implementation date: 1 April 2012)

Voting by poll

The issuer should ensure that shareholders are familiar with the detailed procedures for conducting a poll.

The rule has been amended to allow a chairman at a general meeting to exempt certain prescribed procedural and administrative matters from a vote by poll.

Publishing constitutional documents on website

A new rule requires an issuer to publish an updated and consolidated version of its constitutional documents on its own website and the HKEx website. Any significant changes to constitutional documents during the year in its Corporate Governance Report should be disclosed.

In addition, issuers are required to publish on their websites the procedures shareholders can use to propose a person for election as a director.

(Implementation date: 1 April 2012)

Section F: Company Secretary

The company secretary plays an important role in supporting the board by ensuring good information flow within the board and that board policy and procedures are followed. The company secretary is responsible for advising the board through the chairman and/or the chief executive on governance matters and should also facilitate induction and professional development of directors.

Functions of the Company Secretary

The Company Secretary supports the Chairman in promoting the highest standards of corporate governance, and facilitating the effective functioning of the board and its committees, where appropriate.

- The Company Secretary reports to the Chairman on Board/committee matters and to the Chief Executive on administrative matters. The appointment and removal of the Company Secretary is a matter for the Board as a whole.
- All directors have direct access to the advice and services of the Company Secretary for the ongoing discharge of their duties and responsibilities.
- The key functions of the Company Secretary include:
 - assisting the Chairman in ensuring that there are timely and appropriate information flows to the board and between the non-executive Directors and the management, to enable directors to discharge their responsibilities
 - ensuring that board's policy and procedures, and all applicable rules and regulations, are complied with by each and every director

- ensuring accurate records of board/committee (where appropriate) meeting proceedings, discussions and decisions are recorded
- giving independent, impartial advice to the board on governance matters
- providing updates to the Board on regulatory, CG and CSR issues, new legislations, and directors' duties and obligations
- facilitating induction and professional development of directors
- facilitating communications with shareholders through a variety of means, including annual general meetings, circulars and periodic reports.

The Company Secretary's biography is set out in the annual reports.

In addition to the above, a new section has been added in the CP setting out the role and responsibilities of a company secretary:

- (i) The company secretary should be an employee of the issuer. If the issuer engages an external service provider, it should disclose the identity of the person with sufficient seniority at the issuer for the external provider to contact;
- (ii) The selection, appointment, or dismissal of the Company Secretary should be a board decision;
- (iii) The Company Secretary should report to the board Chairman and/or the Chief Executive; and
- (iv) All directors should have access to the advice and services of the company secretary to ensure that board procedures, and all applicable laws, rules and regulations are followed.

Company Secretary's qualifications, experience and training

The academic or professional qualifications that the Hong Kong Stock Exchange considers acceptable include a member of Hong Kong Institute of Chartered Secretaries, a lawyer or an accountant. Clarification has also been issued regarding the factors the Hong Kong Stock Exchange would consider in assessing "relevant experience". These include the length of employment with an issuer, training received, familiarity with the rules and relevant laws, and qualifications in other jurisdictions.

(Implementation date: 1 January 2012)

Requirement for a Company Secretary to be ordinarily resident in Hong Kong

The requirement for a company secretary to be ordinarily resident in Hong Kong has been removed. This has made the requirements for company secretaries of Mainland issuers the same as for other issuers.

In addition, company secretaries are required to have 15 hours' professional training in a financial year.

(Implementation date: 1 April 2012)

In comparison, the **UK Corporate Governance Code** sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders.

All companies with a premium listing of equity shares in the UK ("premium listed companies") are required under the Listing Rules to report on how they have applied the UK Corporate Governance Code in their annual report and accounts.

The UK Code contains broad principles and more specific provisions, but does not contain recommended best practices. Listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions or – where they have not – to provide an explanation ("comply or explain").

Compared with the HK Code, the UK Corporate Governance Code is substantially more detailed.

2.1.3 Auditors and the Code

The Hong Kong Stock Exchange in October 2011 amended the Main Board/GEM Listing Rules relating to the Corporate Governance Code (“the revised Code”) and associated Listing Rules. One of the amendments of introducing the new provision in the revised Code is that the management of a company should ensure the company’s auditor attends the annual general meeting (“AGM”) to answer questions relevant to:

- (i) the conduct of the audit – responses to questions about the conduct of the audit;
- (ii) the preparation and content of the auditor’s report;
- (iii) the accounting policies adopted by the company in relation to the preparation of the financial statements;
- (iv) the independence of the auditor in relation to the conduct of the audit; and
- (v) modification to the independent auditor’s report, if any

The revised Code is effective from 1 April 2012, and accordingly an auditor is expected to attend and answer questions at an AGM that is held on or after 1 April 2012.

The new Rule requires shareholders’ approval at a general meeting of any proposal to appoint or remove an auditor before the end of the term of his office. The Rule requires the issuer to send a circular containing any written representation from the auditor to shareholders and the auditor must be allowed to make a written and/or verbal representation at the general meeting to remove him.

(Implementation date: 1 January 2012)

2.1.4 Directors

Directors are usually responsible for setting an entity’s strategy, formulating policies and identifying systems and controls and monitoring performance. Let’s break this down further:

Setting strategy and guiding policy

Directors are ultimately responsible for **the safe stewardship of the company**, and this includes all aspects of its management: formulating strategic plans, and translating this into budgets, HR plans, developing and maintaining assets, investing in technology and ensuring corporate governance rules or any industry regulation or tax rules are complied with. One important area in **formulating strategy** is identifying and controlling risks. Internal audit may have a very important role to play in this area, although it is a decision made by the directors as to whether to set up an internal audit department, and if so, to direct relevant work activity to that department.

In an effective board, there should be a balance of power as well as a balance of skills and experience, and a single individual should not be able to dominate the board. One way of achieving this is to comply with the provision in the HK Code that **the roles of Chairman of the board and Chief Executive Officer should be separate** and should not be performed by the same individual. This means that no one individual should have unfettered powers of decision.

The board should also take responsibility for monitoring its own fitness to manage the company. This means an assessment of the knowledge, experience, and skills of the directors in areas core to the entity’s business as well as the directors’ personal characteristics, such as integrity, judgment and available energy and time to invest in the business. It also involves decisions as to new members, good induction procedures and personal development.

The board relies on reliable, timely information from the entity’s systems in order to make decisions and should review the availability and quality of the information available and set up procedures to improve any deficiencies.

Setting up systems, controls and monitoring

Directors are also responsible for the systems used to fulfil the company objectives and the controls put in place to safeguard against risks, a point we will return to later in this chapter. The HK Code requires the boards of listed HK companies to consider **annually whether an internal audit department** is required (HK Code Section C.2.6).

Directors are also responsible for monitoring the effectiveness of the system of internal control and risk management. An internal audit department can support the board in ensuring adequate oversight of internal systems and controls and therefore has a primary role to play in an entity's corporate governance framework.

In the UK, the **Turnbull** report on the review by the board of the effectiveness of internal control and risk management made the following recommendations:

Turnbull Guidelines

Have a **defined process** for the effectiveness of internal control

Review **regular reports** on internal control

Consider **key risks** and how they have been managed

Check the **adequacy of action taken** to remedy weaknesses and incidents

Consider the **adequacy of monitoring**

Conduct an **annual assessment** of risks and the effectiveness of internal control; and

Make a **statement** on this process in the **annual report**

2.1.5 Non-executive directors



Key term

Non-executive directors are directors who do not have day-to-day operational responsibility for the company. They are not employees of the company or affiliated with it in any other way.

Non-executive directors may be independent or they may not be independent. When a non-executive director is considered “not independent”, this means that the individual may be subject to the views and influence of others. For example a non-executive director may represent the interests of a major shareholder, or the director may be subject to the influence of the executive management team, especially after serving as a non-executive director many years.

The Listing Rules provide guidelines on how the “independence” of a non-executive director may be assessed. The HK Code also specifies that if a non-executive director has been on the board for more than nine years, this would be a factor to consider when judging whether he is still independent.

Board composition has a significant impact on corporate performance. The importance of independent non-executive directors is their detachment from the day to day operational responsibility of the company, in other words they are “objective”. As already stated in Section 2.1.2, at least one-third of an issuer's board should be independent non-executive directors (**INEDs**).

A company should also maintain on its website an up-to-date list of all its directors, indicating their function or role and whether they are independent non-executive directors.

Non-executive directors may be appointed to oversee a particular sensitive area such as company reporting, nomination of directors and remuneration of executive directors. Often entities establish sub-committees of board members to deal with these issues. We will consider one such sub-committee, the **audit committee**, in more detail in Section 4.1.



Self-test question 1

The HK Code on Corporate Governance Practices is a Hong Kong Stock Exchange requirement for listed companies. It is recommended for other companies. Some argue that the HK Code should be mandatory for all companies.

Required

- (a) Discuss the benefits of the HK Code to shareholders and other users of financial statements.
- (b) Discuss the merits and drawbacks of having such provisions in the form of a voluntary code.

(The answer is at the end of the chapter)

3 Corporate governance developments in Hong Kong



Topic highlights

Listed companies are required to confirm their compliance with the HK Code or, where they do not comply, to provide explanations for any variation in practice.

3.1 Similarities between the Code in Hong Kong and the UK Corporate Governance Code

When introducing the revised HK Code and the Rules on the CGR in Hong Kong, the Hong Kong Stock Exchange noted that the HK Code represents a significant move towards the adoption of international benchmarks of corporate governance, best practice and disclosure for Hong Kong listed entities. The HK Code has taken into account the UK Corporate Governance Code.

In contrast to other corporate governance reporting regimes, the Hong Kong Code is **broader in coverage but less onerous** in terms of required management action and attestation. This should translate into a corporate governance framework that empowers business to succeed, while not having a significant financial impact.

The Hong Kong Stock Exchange has adopted a “**comply or explain**” approach, (which we discuss in the next Section 3.2) to both Main Board and GEM corporate governance provisions. However, where an issuer chooses not to comply with the relevant Code, the issuer must give considered **reasons for any deviation**, although such deviation may not necessarily constitute a breach of Hong Kong Stock Exchange Listing Rules. In addition, the Hong Kong Stock Exchange requires Main Board and GEM listed companies to include a Corporate Governance Report (CGR) in the annual report. The Hong Kong Stock Exchange sets out **mandatory and recommended disclosures** (discussed in Section 3.6) for inclusion in the CGR. Failure to include any of the mandatory disclosures in the CGR will be regarded by the Hong Kong Stock Exchange as a breach of the Listing Rules.

3.2 Comply or explain approach (principles-based approach)



Topic highlights

Many governance codes have adopted a **principles-based approach** allowing companies **flexibility** in interpreting the codes' requirements and to explain if they have departed from the provisions of the code.

A continuing debate on corporate governance is whether the guidance should predominantly be in the form of principles, or whether there is a need for detailed laws or regulations.

Hong Kong has adopted a non-statutory approach for its corporate governance framework, based on the UK's Corporate Governance Code. This means that the Code is voluntary in nature, with HK companies being asked to “comply or explain” any deviation from the code. The Hong Kong Stock Exchange requires that disclosures be made as to whether it has been complied with, but there are **no statutory requirements to comply**.

Principles-based approaches have often been adopted in jurisdictions where the governing bodies of **stock markets** have had the prime role in setting standards for companies to follow. By comparison the USA has adopted a more rules-based approach in their corporate governance framework.

3.2.1 Benefits of comply or explain approach (principles-based approach)

Possible benefits of basing corporate governance codes on a series of principles are as follows:

- (a) The approach focuses on **objectives** (for example, the objective that shareholders holding a minority of shares in a company should be treated fairly) rather than the mechanisms by which these objectives will be achieved. Possibly therefore, principles are **easier to integrate into strategic planning**.
- (b) Principles-based approaches can be applied across **different legal jurisdictions** rather than being founded in the legal regulations of one country. The OECD Principles are a good example of guidance that is applied internationally. This will increase global harmonisation.
- (c) Where principles-based approaches have been established in the form of corporate governance codes, the specific recommendations that the codes make are generally enforced on a **comply or explain basis**. Listing Rules include a requirement to comply with codes, but because the guidance is in a form of a code, companies have **more flexibility** than they would if the code was underpinned by legal requirements.
- (d) The **disclosure** requirements ensure that **shareholders** are **aware** of the position and they can make any points they want to about compliance with the code at the AGM.
- (e) It has been argued that making such a code obligatory would have **punitive effects** on some companies, due to their size or investor make up and that legislation would create a **burden of requirement** which **could be excessive in many cases**. Therefore, it is less burdensome in **terms of time and expenditure**.
- (f) A **principles-based approach** allows companies to **develop their own approach** to corporate governance that is appropriate for their circumstances within the limits laid down by stock exchanges.
- (g) Enforcement on a **comply or explain basis** means that businesses can explain why they have departed from the specific provisions if they feel it is appropriate. In many instances now, the departures from best practice described in reports are of a minor or temporary nature. Explanations of breaches have generally included details of how and when non-compliance will be remedied.

3.2.2 Criticisms of comply or explain approach

- (a) A principles-based approach can lay stress on those elements of corporate governance to which rules **cannot easily be applied**. These include overall areas such as the requirement to maintain sound systems of internal control, and “softer” areas such as organisational culture and maintaining good relationships with shareholders and other stakeholders.
- (b) Disclosure of non-compliance is insufficient as the AGM is still not sufficient protection for shareholders.
- (c) Having a voluntary code allows some companies not to comply freely, to the detriment of their shareholders.
- (d) The requirement to disclose is only a Stock Exchange requirement, and there are many unlisted companies who should be encouraged to apply the codes.

- (e) There may be **confusion over what is compulsory and what isn't**. Although codes may state that they are not prescriptive, their adoption by the local stock exchange means that specific recommendations in the codes effectively become rules, which companies have to **obey in order to retain their listing**.
- (f) Some companies may perceive a principles-based approach as **non-binding** and fail to comply without giving an adequate or perhaps any explanation. Not only does this demonstrate a failure to understand the **purpose of principles-based codes** but it also casts aspersions on the integrity of the companies' decision-makers.

3.3 Application of principles-based approaches by investors

In practice, comply or explain has not led to lots of companies treating compliance as being voluntary. Analysts and investors have taken breaches, particularly by larger listed companies, very seriously. The reputation of companies has been adversely affected if they have tried to justify non-compliance on the grounds of excessive trouble or cost. However the value of smaller or recently listed companies has been less affected by non-compliance; stock markets have effectively allowed these companies more latitude even though they have breached the governance codes.

The governments have shown concerns for this area in the past and it is believed that they **might take actions in the future to regulate this area** more heavily.

However, at the moment, having a **voluntary code is a compromise** based on the points made above.

3.4 Current issues

Some observers attributed the global economic downturn from 2008 to a failure of those in corporate governance, such as non-executive directors and audit committees, to manage risk effectively. In particular, several banks in the USA and Europe were criticised for poor governance and a failure to understand the risk exposures the banks are facing. Other observers argue that it is not fair to blame directors who, due to rigorous independence requirements, may only have a limited knowledge of the business or industry and are only allocated a few days a month to their role. There seems to be an expectations gap between what is expected of those in corporate governance and the tasks they can reasonably be required to do.

It is likely that corporate governance regulation will be reviewed as regulators react to the situation. However, it is important that any changes are carefully considered and not just quickly implemented regulations to appease public opinion.

While it stressed that a different code may not have prevented the current economic conditions, it is thought that it is an appropriate time to examine its effectiveness.

3.5 Structure of the Code in Hong Kong

Over the years, HKEx has undertaken a series of initiatives to raise the standards of corporate governance in Hong Kong, improving the quality of disclosures and fostering corporate governance culture amongst issuers in Hong Kong.

As stated earlier, the HK Code sets out the principles of good corporate governance, and two levels of recommendations: (a) code provisions; and (b) recommended best practices. Hong Kong listed companies are expected to comply with the code provisions (or explain any non-compliance). The recommended best practices are for guidance only. Issuers may also devise their own code on corporate governance practices on such terms as they may consider appropriate.

For the deviations the listed company must provide **reasons** in the annual reports and interim reports.

The Code is structured in the following sections:

- A Directors
- B Remuneration of directors and senior management and board evaluation
- C Accountability and audit
- D Delegation by the board
- E Communication with shareholders
- F Company secretary

The main provisions in the HK Code are set out below.

Key provisions of the HK Code

Section A Directors

- Every company should be headed by an effective board, which is responsible for leadership and control and for promoting the success of the company.
- The board should meet regularly where appropriate agenda, meeting notices and meeting minutes are prepared.
- The **roles of Chairman and Chief Executive Officer should be separated** and should not be performed by the same individual.
- At least one-third of an issuer's board should be independent non-executive directors (**INEDs**).
- There should be a formal, considered and transparent procedure for the **appointment of new directors** to the board. There should be regular re-elections of all directors at regular intervals. Non-executive directors should be appointed for a specific term and subject to election. Their term of appointment must be disclosed in the Report in accordance with the Listing Rules. Shareholders should vote on a separate resolution to retain an INED who has served on the board for more than nine years.
- The board should regularly review the contribution by a director to performing his responsibilities to the issuer, and whether he is spending sufficient time performing them.
- Directors should inform the issuer of any change to directors' significant commitments in a timely manner.
- Every director should be subject to retirement by rotation at least once every three years.
- The reason for the resignation and removal of a director must be explained.
- Every director should keep abreast of his responsibilities as a director of the company, the conduct and development of that company.
- The board should be provided with timely information in a form and of a quality appropriate to enable it to discharge its duties. All directors are entitled to have access to board papers and related materials.
- All directors should **receive induction** on joining the board and should regularly update and refresh their skills and knowledge by participating in continuous professional development. Subsequently such briefings and professional development should be on an "as is necessary" basis.
- There should be a procedure agreed by the Board to enable directors, upon reasonable request, to seek independent professional advice in appropriate circumstances, at the company's expense.
- Directors should provide records of directors' training they received to issuers.

Key provisions of the HK Code

Section B Remuneration of directors and senior management and board evaluation

- The company should establish a **remuneration committee**, consisting of the majority of independent executive directors who should consult the Chairman and/or Chief Executive Officer about its proposals relating to the remuneration of the executive directors.
- Levels of remuneration should be **sufficient to attract, retain and motivate** directors of the quality required to run the company successfully, but a company should avoid paying more excessive amounts than is necessary for this purpose. **(It should be noted that this is a principle in the HK Code, not a provision.)**
- Senior management remuneration should be disclosed by band.
- The issuers should disclose the remuneration of a Chief Executive who is not a director.

Section C Accountability and audit

- Management should provide such information to the board that will enable the board to make an informed assessment of the financial and other information that is presented to them for approval.
- The directors should acknowledge in the Corporate Governance Report (CGR) their responsibility for preparing the financial statements and there should be a statement by the external auditors about their reporting responsibilities in the auditor's report on the financial statements.
- The board should prepare the financial statements on a going concern basis unless the board is aware of material uncertainties relating to events or conditions that may cast significant doubt upon the company's ability to continue as a going concern.
- The board should present a balanced, clear and comprehensive assessment of the company's position, performance and prospects.
- The board should maintain a **sound system of internal control** to safeguard shareholders' investment and the company's assets.
- The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and report to shareholders that they have done so in their annual report. The review should consider the adequacy of resources, qualifications and experience of staff of the issuer's accounting and financial reporting functions, and their training programmes and budget.

Key provisions of the HK Code

Section D Delegation by the board

- When the board delegates aspects of its management and administration functions to management, it must give clear directions to management as to the powers they have been given. In particular, the board must specify the circumstances where management must report back to the board and obtain prior approval before making a decision or making commitments on behalf of the company.
- When a board committee is established, it should be given clear terms of reference to enable it to discharge its responsibilities effectively. These terms of reference should include a requirement for the committee to report back to the full board on their decisions or recommendations.
- The board should not delegate matters to a board committee, executive directors or management to an extent that would reduce its ability to discharge its functions properly.
- There should be a formal list of matters that are reserved for decision-making by the board, that the board must not delegate.

Section E Communications with shareholders

- A principle in the Code is that the board should maintain on-going communication with shareholders and in particular, use annual general meetings (AGM) or other general meetings to communicate with shareholders and encourage their participation.
- The Code provisions about communications with shareholders relate to general meetings, such as a requirement to have a separate resolution for each substantial issue of shareholding, and sending out the notice of the annual general meeting well in advance. At the beginning of a general meeting the Chairman should also explain the detailed procedures for conducting a poll.
- Issuers should establish a shareholder communication policy.

Section F Company Secretary

- The Company Secretary should be an employee of the issuer and have day-to-day knowledge of the issuer's affairs.
- The board should approve the selection, appointment or dismissal of the Company Secretary.
- The Company Secretary should report to the board Chairman and/or the Chief Executive.
- All directors should have access to the advice and services of the Company Secretary to ensure that board procedures, and all applicable law, rules and regulations, are followed.
- The academic or professional qualifications that the Hong Kong Stock Exchange would consider acceptable include a member of Hong Kong Institute of Chartered Secretaries, a lawyer or an accountant.
- Factors the Hong Kong Stock Exchange will consider in assessing "relevant experience" include the length of employment with an issuer, training received, familiarity with the rules and relevant laws, and qualifications in other jurisdictions.
- The company Secretary should have 15 hours' professional training in a financial year.

3.6 Corporate Governance Report (CGR) in Hong Kong

As stated, listed companies are required to include a CGR in each annual report and summary financial report (if any). The rules on the CGR set out two levels of disclosure:

- **Mandatory disclosure requirements:** Failure to include these mandatory disclosure in the CGR will be regarded by the Hong Kong Stock Exchange as a breach of the Listing Rules.
- **Recommended disclosure requirements:** The Hong Kong Stock Exchange notes that the list of recommended disclosures is provided for listed companies' references and is not intended to be mandatory. The listed companies are encouraged to state whether they have complied.

Mandatory disclosure requirements	Recommended disclosure requirements
<ul style="list-style-type: none"> • Narrative statement about how the principles of the Code have been applied. A statement of compliance with the Code provisions or an explanation of any non-compliance • Details of board members • Directors' securities transactions • Non-executive directors' terms of appointment • Identity and segregation of Chairman and Chief Executive Officer • Directors' remuneration policy • Nomination committee information • Auditors' remuneration • Audit committee information • Board diversity policy 	<ul style="list-style-type: none"> • Shareholders' rights • Share interests of senior management • Investor relations • Division of responsibility between the board and management • Additional disclosures regarding internal control

According to HKSA 720 (Clarified) *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*, the auditor should read the narrative statement of how a listed company has complied with the principles in the HK Code for any inconsistencies with the audited financial statements.

A new CP states that the annual report should include an explanation of the basis on which the company generates or preserves value over the longer term and the strategy for delivering the objectives of the company.

In addition, the Hong Kong Stock Exchange has amended the Rule to remove the requirement for issuers to publish a Next Day Disclosure Form following the exercise of an option for shares in the issuer by a director of its subsidiaries so that options for shares in the issuer exercised by a director of a subsidiary only triggers an announcement if the change in its share capital, individually or when aggregated with other events, is 5% or more since its last Monthly Return.

3.7 The New Hong Kong Companies Ordinance

A comprehensive exercise to rewrite the Companies Ordinance (Cap. 32) was launched in mid-2006 with the aim of modernising Hong Kong's company law and further enhancing Hong Kong's status as a major international business and financial centre. The **Companies Bill** was finalised and introduced into the Legislative Council ("the LegCo") on 26 January 2011. On 12 July 2012, the Companies Bill was passed by the LegCo.

The New Companies Ordinance ("the new CO"), which consists of more than 900 sections and 11 schedules, provides a modernised legal framework for the incorporation and operation of companies in Hong Kong. It aims to achieve four main objectives, namely, to enhance corporate governance, ensure better regulations, facilitate business and modernise the law.

To facilitate implementation of the new CO, over ten regulations will have to be made in 2013-14. In parallel, the Companies Registry will enhance its information system and carry out an overall review of its procedures and forms for the implementation of the new legislation. **The new CO is expected to commence operation in 2014.**

Under the new CO, there are new measures for enhancing corporate governance and the following are some of the major measures for the enhancement:

(a) **Strengthening the accountability of directors**

Restricting the appointment of corporate directors by requiring every private company to have **at least one natural person to act as director**, to enhance transparency and accountability.

Clarifying in the statute the directors' duty of care, skill and diligence with a view to providing clear guidance to directors.

(b) **Enhancing shareholder engagement in the decision-making process**

Introducing a **comprehensive set of rules for proposing and passing a written resolution.**

Requiring a company to bear the expenses of circulating members' statements relating to the business of, and proposed resolutions for, Annual General Meetings, if they are received in time to be sent with the notice of the meeting.

Reducing the threshold requirement for members to demand a poll from 10% to 5% of the total voting rights.

(c) **Improving the disclosure of company information**

Requiring public companies and the larger (i.e., companies that do not qualify for simplified reporting) private companies and guarantee companies to **prepare a more comprehensive directors' report** which includes an analytical and forward-looking "business review", whilst allowing private companies to opt out by special resolution. The business review will provide useful information for shareholders. In particular, the requirement to include information relating to environmental and employee matters that have a significant effect on the company is in line with international trends to promote corporate social responsibility.

(d) **Fostering shareholder protection**

Introducing more effective rules to **deal with directors' conflicts of interests**, including expanding the requirement for seeking shareholders' approval to cover directors' employment contracts which **exceed three years.**

Requiring disinterested shareholders' approval in cases where shareholders' approval is required for transactions of public companies and their subsidiaries.

Requiring the conduct of directors to be ratified by disinterested shareholders' approval to prevent conflicts of interest and possible abuse of power by interested majority shareholders in ratifying the unauthorised conduct of directors.

Replacing the "headcount test" with a not more than 10% disinterested voting requirement for privatisations and specified schemes of arrangement, while giving the court a new discretion to dispense with the test (in cases where it is retained) for members' schemes.

Extending the scope of the unfair prejudice remedy to cover "proposed acts and omissions", so that a member may bring an action for unfair prejudice even if the act or omission that would be prejudicial to the interests of members is not yet effected.

(e) Strengthening auditors' rights

Empowering an auditor to require a **wider range of persons**, to provide information or explanation reasonably required for the performance of the auditor's duties. This includes the officers of a company's Hong Kong subsidiary undertakings and any person holding or accountable for the company or its subsidiary undertakings' accounting records. The offence for failure to provide the information or explanation is extended to cover officers of the company and the wider range of persons.

4 Board committees



Topic highlights

Many companies operate a series of board **sub-committees** responsible for supervising specific aspects of governance. Operation of a committee system does not clear the main board of its responsibilities for the areas covered by the board committees.

Good use of committees seems to have had a positive effect on the governance of many companies. It is found that committees had given assurance that important board duties were being discharged rigorously.

The main board committees are:

- **Audit committee** – arguably the most important committee, responsible for liaising with external audit, supervising internal audit and reviewing the annual financial statements and internal controls
- **Nomination committee** – responsible for recommending the appointments of new directors to the board
- **Remuneration committee** – responsible for advising on executive director remuneration policy and the specific package for each director
- **Risk committee** – responsible for overseeing the organisation's risk response and management strategies

Corporate governance guidance has concentrated on the work of the audit, remuneration and nomination committees. The corporate governance report recommends that no one individual should serve on all committees; most reports recommend that the committees should be staffed by non-executive directors and preferably INEDs. We shall now consider the role of committees to see why their role is deemed to be so significant.

4.1 Audit committees



Topic highlights

An **audit committee** can help a company maintain objectivity with regard to financial reporting and the audit of financial statements.

Appendix 14, Section C.3 of the HK Code sets the **minimum duties for the audit committee** and Section B.1 covers the remuneration committee. The HK Code further determines the role of the audit committee and its role in monitoring the integrity of the company's financial statements as well as being primarily responsible for the company's relationship with the external auditors, reviewing the internal controls and recommending the appointment of external auditors. The company should provide sufficient resources to the audit committee to discharge its duties.

A former partner of the company's existing auditing firm should be prohibited from acting as a member of the company's audit committee for a period of one year commencing on the date of

ceasing to be partner of the auditing firm or ceasing to have any financial interest in the auditing firm (whichever is later).

4.1.1 Role and function of audit committees

An audit committee should be set up. It should consist entirely of non-executive directors and there should be **at least three non-executive directors** on the committee. The board should satisfy itself that at least one member of the audit committee is an independent non-executive director who has appropriate professional qualifications, or accounting or related financial management expertise.

The majority of the audit committee members must be independent non-executive directors, and the chairman of the audit committee must be an independent non-executive director as well.

The exact role of an audit committee will vary from entity to an entity. The audit committee terms of reference should be set out in writing and publicly available or described in a report.

The Code requires that the board should establish formal and transparent arrangements for considering how it should apply the financial reporting and internal control principles for maintaining an appropriate relationship with the company's auditors. The provisions relating to this principle are set out below.

Code provisions relating to the audit committee in Hong Kong

Chapter 3, section 3.21 of the Main Board Listing Rules requires:

'Every listed issuer must establish an audit committee comprising non-executive directors only. The audit committee must comprise a minimum of three members, at least one of whom is an independent non-executive director with appropriate professional qualifications or accounting or related financial management expertise as required under rule 3.10(2). The majority of the audit committee members must be independent non-executive directors of the listed issuer. The audit committee must be chaired by an independent non-executive director.'

The GEM Board (Growth Enterprise Market) has similar requirements in Chapter 5, Section 5.28 covering Audit Committees.

For further assistance the HKICPA (formerly known as the Hong Kong Society of Accountants) published in February 2002, "A Guide for Effective Audit Committees". Listed issuers may refer to the terms of reference set out in this Guide, or they may adopt any other comparable terms of reference for the establishment of an audit committee.

The main role and responsibilities should be set out in **written terms of reference** and should include:

- (a) To monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting issues and judgments contained in them.

The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

- (b) To review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors or by the board itself, the company's internal control and risk management systems.

- (c) To monitor and review the effectiveness of the company's internal audit function. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.
- (d) To make recommendations to the board on the appointment, reappointment and removal of the external auditors, to approve the remuneration and terms of engagement of the external auditors and any questions of resignation or dismissal of the external auditors (section C.3.3(a) of Appendix 14).

If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

- (e) To monitor and review the external auditor's independence, objectivity and effectiveness of the audit process in accordance with applicable standards (section C.3.3(b) of Appendix 14).
To seek information from the external auditors on an annual basis on the external auditors' processes for maintaining independence and monitoring compliance with relevant requirements, including any applicable requirement on rotation of engagement team members.
- (f) To develop and implement policy on engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provisions of non-audit services by the external audit firm and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken (section C.3.3(c) of Appendix 14).
- (g) The amended CP states that **an audit committee should meet the external auditor at least twice a year.**
- (h) To ensure co-ordination between the internal audit function (where it exists) and the external auditors.
- (i) To review the external auditors' management letter, any material queries raised by the external auditors to management in respect of the accounting records, financial statements or systems of control and management's response.
- (j) To ensure that the board provides a timely response to the issues raised in the external auditors' management letter.
- (k) The RBP was upgraded to CP, stating that an audit committee's terms of reference should include arrangements for employees to raise concerns about financial reporting improprieties; and
- (l) A new RBP was introduced recommending the audit committee establish a whistleblowing policy and system.

All these new amendments should be implemented commencing on 1 April 2012.

4.1.2 Advantages and drawbacks of audit committees

The advantages of having an audit committee are as follows:

- (a) To improve the quality of financial reporting, by reviewing the financial statements on behalf of the board.
- (b) To create an ethical environment and establish controls which will act as a deterrent and reduce the opportunity for fraud.

- (c) To enable the non-executive directors to inject their experience, expertise and an independent judgment into the entity's affairs.
- (d) To help the Chief Financial Officer, by providing a forum in which he can raise matters of concern, and a mechanism for resolving potentially difficult issues.
- (e) To work with and improve the quality and efficiency of the external auditor, by providing a means of communication and apparatus to resolve issues of concern.
- (f) To provide a framework within which the external auditor can assert his position in the event of a dispute with management.
- (g) To strengthen the status of the internal audit function, by providing a greater degree of independence from management.
- (h) To increase public confidence in the reliability and objectivity of financial statements.

Opponents of audit committees argue the following:

- (a) The executive directors may **not understand** the purpose of an audit committee and may perceive that it detracts from their authority.
- (b) There may be **difficulty selecting** sufficient non-executive directors with the necessary competence in auditing matters for the committee to be really effective.
- (c) The establishment of such a **formalised reporting procedure** may **dissuade** the **auditors** from raising matters of judgment and limit them to reporting only on matters of fact; and
- (d) **Costs** may be **increased**.

4.2 Nomination committee

4.2.1 Role and function of nomination committee

In order to ensure that balance of the board is maintained, corporate governance codes recommend the board should set up a **nomination committee**, to oversee the process for board appointments and make recommendations to the board. The nomination committee needs to consider:

- the **skills, knowledge** and **experience** possessed by the current board
- the **need for continuity** and succession planning
- the desirable **size** of the board
- the need to attract board members from a **diversity** of backgrounds

New CPs have been introduced and have stated that a listed company should:

- (a) establish a nomination committee with a majority of INEDs, chaired by an INED or the board Chairman;
- (b) establish a nomination committee with written terms of reference that performs the duties described;
- (c) include, as one of the nomination committee's duties, a review of the structure, size and composition of the board at least annually to complement the issuer's corporate strategy;
- (d) make the nomination committee's terms of reference available on both the issuer's and the HKEx websites;
- (e) ensure a nomination committee has sufficient resources; and
- (f) enable a nomination committee to seek independent professional advice at the issuer's expense.

4.3 Remuneration committee

4.3.1 Role and function of remuneration committee

In Hong Kong, the key objectives of establishing a remuneration committee are to assist the board of directors in maintaining a formal and transparent procedure for setting policy on directors' remuneration, and to determine an appropriate remuneration package for all directors. The remuneration committee should ensure that remuneration arrangements support the strategic aims of the business, and enable the recruitment, motivation and retention of senior executives while complying with all rules and regulations. According to the new revised rules issuers should establish a remuneration committee with specific written terms of reference which deal clearly with its authority and duties. A majority of the members of the remuneration committee should be independent non-executive directors. The Chairman of the remuneration committee should be an INED.

There should be written terms of reference for the remuneration committee. Any listed company that fails to comply with these rules should immediately announce its reasons for not doing so and any other relevant details. The listed company will have a three-month period to rectify its non-compliance.

The remuneration committee should consult the Chairman and/or Chief Executive Officer about their proposals relating to the remuneration of other executive directors. Where necessary it adds that professional advice can be sought by the remuneration committee, however any professional advice made available to a remuneration committee should be independent;

The remuneration committee should only perform an advisory role to the board, with the board retaining the final authority to approve executive directors' and senior management's remuneration.

It is suggested to remove the term "performance-based" from the CP describing executive directors' and senior management's remuneration. It should ensure that the remuneration committee's terms of reference are available on both the issuer's and the Hong Kong Stock Exchange websites.

All the new revisions should be implemented commencing on 1 April 2012.

Overall, the remuneration committee plays the key role in establishing remuneration arrangements. In order to be effective, the committee needs both to **determine** the organisation's **general policy** on the **remuneration of executive directors** and **specific remuneration packages** for each director.



Self-test question 2

- Summarise the principles in the HK Corporate Governance Code relating to remuneration of directors.
- Describe the main areas of concern that should be addressed by a remuneration committee.
- Explain the relationship between the audit committee and the public sector.

(The answer is at the end of the chapter)

5 Management's responsibilities to comply with corporate governance requirements

The powers of directors to run the company are set out in the company's **constitution or articles of association**.

Under corporate governance best practice there is a distinction between the role of **executive directors**, who are involved **full-time in managing the company**, and the **non-executive directors**, who primarily focus on **monitoring**. However, under Companies Law, in most

jurisdictions the legal duties of directors apply to both executive and non-executive directors. Section A of Appendix 14 covers the issues relating to directors.

5.1 Duties of directors

The corporate governance reports have aimed to build on the directors' duties as defined in statutory and case law duties of directors. These include the **fiduciary duties** to act in the **best interests of the company**, use their powers for a **proper purpose**, **avoid conflicts of interest** and exercise a **duty of care**.

5.2 Composition and balance of the board

A feature of many corporate governance scandals has been boards dominated by a **single senior executive** with other board members merely acting as a rubber stamp. Sometimes the single individual may bypass the board to action his own interests. Even if an organisation is not dominated by a single individual, there may be other weaknesses in board composition. The organisation may be run by a small group centred round the Chief Executive and Chief Financial Officer, and appointments may be made by personal recommendation rather than a formal, objective process.

As we shall see, the board must also be **balanced** in terms of skills and talents from several **specialisms** relevant to the organisation's situation.

5.3 Reliability of financial reporting and external auditors

Issues concerning **financial reporting and auditing** are seen by many investors as crucial because of their central importance in ensuring management accountability. They have therefore been the focus of much debate and litigation. While focusing the corporate governance debate solely on accounting and reporting issues is inadequate, the greater regulation of practices such as off-balance sheet financing has led to **greater transparency** and a **reduction in risks** faced by investors.

External auditors may not carry out the necessary questioning of senior management because of fears of **losing the audit**, and internal auditors do not ask awkward questions because the Chief Financial Officer **determines their employment prospects**. Often corporate collapses are followed by criticisms of external auditors, where poorly planned and focused audit work failed to identify illegal use of client monies.

5.4 Directors' remuneration and rewards

Packages will need to **attract, retain and motivate directors** of sufficient quality, while at the same time taking into account shareholders' interests as well. However, assessing executive remuneration in an imperfect market for executive skills may prove problematic. The remuneration committee needs to be mindful of the **implications of all aspects** of the package, also the individual contributions made by each director.

Directors being paid excessive salaries and bonuses has been seen as one of the major corporate abuses for a large number of years. It is therefore inevitable that the corporate governance codes have targeted this issue, with such measures as:

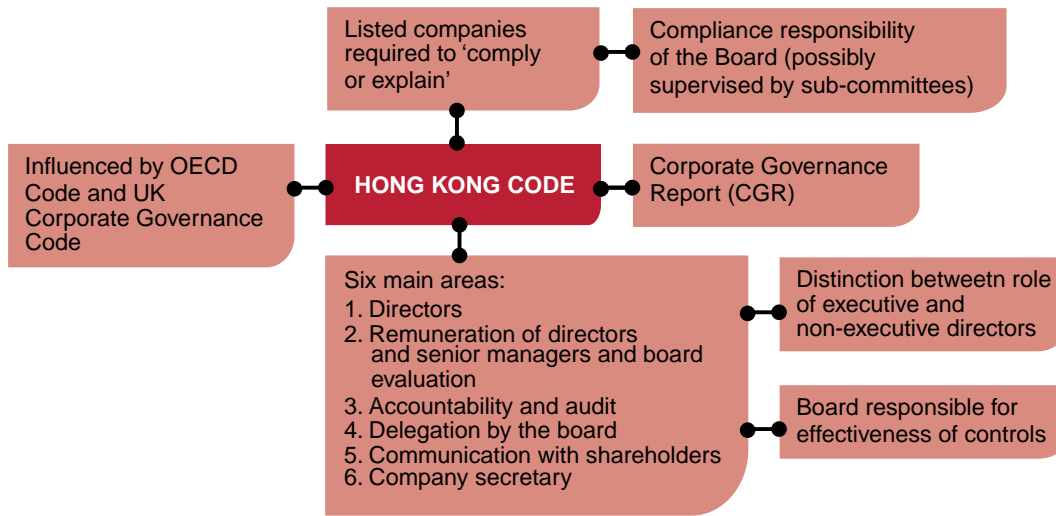
- (a) directors' remuneration should be set by **independent members** of the board
- (b) any form of bonus should be related to **measurable performance** or enhanced shareholder value; and
- (c) there should be **full transparency of directors' remuneration**, including pension rights, in the annual financial statements

In order for readers of the financial statements to achieve a fair picture of remuneration arrangements, the annual report would need to disclose:

- remuneration policy; and
- arrangements for individual directors

Other disclosures that may be required by law or considered as good practice include the **duration of contracts with directors**, and **notice periods and termination payments** under such contracts. Details of **external remuneration consultants** employed by the remuneration committee to advise on determining remuneration should be provided.

Topic recap



Answers to self-test questions

Answer 1

(a) Benefits of the HK Code

Shareholders

Of key importance to the shareholders are the suggestions that the HK Code makes in respect of the **annual general meeting**. In the past, particularly for large listed companies, AGMs have sometimes been forbidding and unhelpful to shareholders. The result has been poor attendance and low voting on resolutions.

The HK Code requires that separate **resolutions** are made for identifiably different items which should assist shareholders in understanding the proposals laid before the meeting.

It also requires that **director** members of various important board committees (such as the remuneration committee) be **available** at AGMs to answer shareholders' questions.

Internal controls

Another important area for shareholders is the emphasis placed on directors monitoring and assessing **internal controls** in the business on a regular basis. While it is a statutory requirement that directors safeguard the investment of the shareholders by instituting internal controls, this additional emphasis on quality should increase shareholders' confidence in the business.

Directors re-election

The requirements of the HK Code also make the **directors more accessible** to the shareholders. They are asked to submit to re-election every three years. They are also asked to make disclosure in the financial statements about their responsibilities in relation to preparing financial statements and going concern.

Audit committee

Last, some people would argue that the existence of an **audit committee** will lead to shareholders having greater confidence in the reporting process of an entity.

Other users

The key advantage to other users is likely to lie in the increased emphasis on internal controls as this will assist the company in operating smoothly and increasing viability of operations, which will be of benefit to customers, suppliers and employees.

(b) Voluntary code

Adherence to the HK Code is not a statutory necessity, although it is possible that in the future, such a code might become part of company law.

Advantages

The key merit of the HK Code being voluntary for most companies is that it is **flexible**. Companies can review the Code and make use of any aspects which would benefit their business.

If they adopt aspects of the HK Code, they can disclose to shareholders what is being done to ensure **good corporate governance**, and what aspects of the HK Code are not being followed, with reasons.

This flexibility is important, for there will be a **cost of implementing** such a Code, and this cost might outweigh the benefit for small or owner-managed businesses.

Disadvantages

Critics would argue that a voluntary code allows companies that should comply with the Code to **get away with non-compliance** unchallenged.

They would also argue that the **type of disclosure** made to shareholders about degrees of compliance could be **confusing and misleading** to shareholders and exacerbate the problems that the Code is trying to guard against.

Answer 2

- (a) Remuneration levels should be sufficient to attract directors of **sufficient calibre** to run the company effectively, but companies should not pay more than is necessary.

Directors should consider whether to include **compensation commitments** in the contracts of service.

Companies should establish a formal and clear procedure for **developing policy on executive remuneration** and for fixing the remuneration package of individual directors. **Directors should not be involved in setting their own remuneration.** A **remuneration committee**, staffed by non-executive directors (NEDs), should make **recommendations** about the framework of executive remuneration, and should determine specific remuneration packages. The board should determine the remuneration of NEDs.

- (b) The remuneration committee should consider the following:

- Choice of criteria through which performance is measured, including the goals of the organisation
- Time scales over which performance is measured
- The balance between the historic assessment and the potential impact of decisions
- Differentials between different members of the board
- The need to retain good quality directors
- Public perceptions of pay awarded to directors
- Shareholder perceptions of pay awarded to directors

Of particular importance is the need to align medium to long-term performance outcomes with remuneration packages, and to avoid short-term rewards for results that may not necessarily be in the medium to long-term interests of the company.

- (c) The audit committee is an integral element of public accountability and governance. It plays a key role with respect to the integrity of the entity's financial information, its system of internal controls, and the legal and ethical conduct of management and employees. An audit committee's responsibility will vary depending upon the entity's complexity, size, and requirements. Typical audit committee responsibilities include approving the overall audit scope, recommending the appointment of the external auditor, overseeing the entity's financial statements and internal controls, helping to ensure that the audit is conducted in a cost-effective manner, and risk management oversight.

Audit committees are an increasingly important component of effective accountability and governance. An audit committee must have three important qualities in order to fulfil its duties: independence, communication, and accountability.

Independence. In the public sector, the structure of entities does not separate the governing authority and oversight responsibility from the day-to-day management. For example, a public university president may be both the Chief Executive Officer and a board member. Public sector audit committees should be independent both in fact and in appearance, and have processes in place to ensure such independence.

Communication. Communication between a governing body and its finance officers can be difficult at times. For example, external financial reporting follows standard principles; however, budgets and expressions of policy are unique to the circumstances of the organisation and its jurisdiction. Communication may be complicated when a governing body approves a budget but not the financial statements. The GAO has indicated that audit committees can provide assistance if they have the necessary technical skills in accounting and auditing and are able to communicate with finance officers and auditors on complex issues.

Accountability. An audit committee must be independent to contribute to the integrity of the financial reporting process. An independent audit committee can help reinforce a culture with zero tolerance for fraud.

Exam practice



DREIT

25 minutes

Dummy Real Estate Investment Trust (DREIT) is a mid-size real estate investment trust listed in Hong Kong. With a portfolio of 50 real estates comprising retail malls, commercial premises and car park facilities, DREIT was established by a trust deed (Trust Deed).

DREIT has a manager (Manager) who has the general power to manage DREIT's assets in the interests of its unitholders (Unitholders) in accordance with the Trust Deed. A Board of Directors is responsible for the Manager's overall governance, including establishing targets for executive management and monitoring the achievement of these targets. DREIT's trustee (Trustee) is responsible under the Trust Deed for the safe custody of DREIT's assets and holds the same for and on behalf of the Unitholders. The Manager is independent of the Trustee.

DREIT aims to produce a sustainable stream of income from its portfolio and to maximise the value through the enhancement of its physical built structure, trade-mix, marketing and customer service. As these enhancement projects progress, the portfolio offers customers better shopping facilities with more choices at reasonable prices, whilst improving returns for the Unitholders.

Since its listing on the Hong Kong Stock Exchange in December 20X8, DREIT has been paying the Unitholders at about 90% of its net income and has demonstrated consistent growth in distribution per unit. A substantial portion of the remuneration of DREIT's senior executives is closely linked to the growth rate of the distribution per unit.

Certain DREIT's financial and operating data are set out as follows:

	Year ended 31 December 20Y0	Year ended 31 December 20X9
Revenue	HK\$404 million	HK\$385 million
Net property income margin	35%	35%
Distribution per unit	49 cents	43 cents
Average monthly unit rent	HK\$26 per square foot	HK\$26 per square foot
Occupancy rate	91%	87%
Gearing	20%	18%

Mr Kwok is the audit director of a CPA incorporated practice in charge of the audit of DREIT's financial statements for the year ended 31 December 20Y0.

In April 20Y0, DREIT made an acquisition of a block of low-rise commercial premises in the New Territories. Part of the premises suddenly collapsed in December 20Y0. There was no casualty reported and DREIT's manager believed that the damages are fully covered by its group insurance policy. However, emerging evidence indicates that there was an illegal extension built on the premises which might have caused the collapse. If it is the case, the damage could be an uninsured loss.

(**Note.** DREIT is a collective investment scheme in the form of a unit trust established by a trust deed, authorised by the Securities and Futures Commission under the Securities and Futures Ordinance and regulated by the provisions of the Code on Real Estate Investment Trusts.)

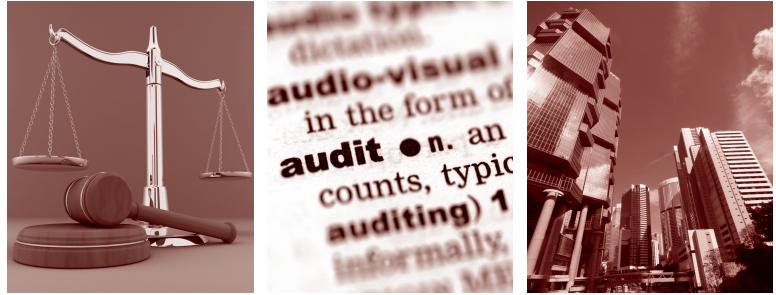
DREIT has established an audit committee to comply with the Listing Rules of the Hong Kong Stock Exchange.

Required

- (a) To what extent can the establishment of an effective audit committee improve DREIT's corporate governance in the context of external auditing, financial reporting and internal control? **(8 marks)**
- (b) Describe some ways to gauge the effectiveness of DREIT's audit committee. **(6 marks)**

(Total = 14 marks)

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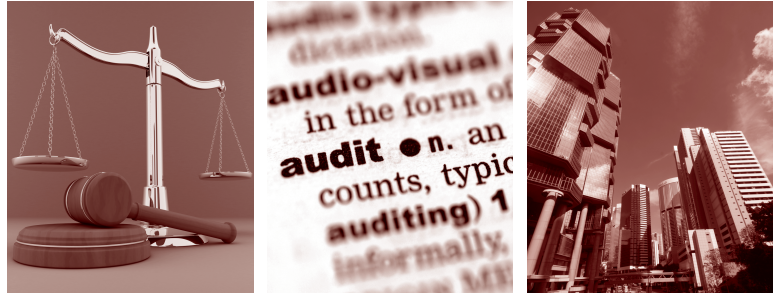


Part B

Internal assurance

Internal assurance is an important concept linked to a good corporate governance environment.

A discussion of internal assurance helps students to perform the environmental consideration for assurance purposes. Internal assurance is also an input to the audit risk assessment process.



chapter 3

Internal assurance

Topic list

1 Internal control effectiveness

- 1.1 Importance of internal control and risk management
- 1.2 Directors' responsibilities for internal control
- 1.3 Annual assessment of the internal control effectiveness
- 1.4 Auditors' responsibilities for internal control

2 Internal audit and corporate governance

- 2.1 Introduction
- 2.2 Internal audit and corporate governance
- 2.3 The role of internal audit in risk management
- 2.4 Outsourcing the internal audit function
- 2.5 Managing an outsourced department

3 Sarbanes-Oxley Act 2002

- 3.1 The Enron scandal
- 3.2 The Sarbanes-Oxley Act 2002
- 3.3 Detailed provisions of the Sarbanes-Oxley Act
- 3.4 Impact of Sarbanes-Oxley in America
- 3.5 International impact of Sarbanes-Oxley
- 3.6 Impact of Sarbanes-Oxley in Hong Kong
- 3.7 Criticisms of Sarbanes-Oxley

4 Internal auditors

- 4.1 Using the work of internal auditors
- 4.2 Relationship between HKSA 315 (Revised) and HKSA 610 (Revised 2013)
- 4.3 Internal audit function
- 4.4 Evaluating the internal audit function
- 4.5 Using the work of the internal audit function
- 4.6 Using internal auditors to provide direct assistance
- 4.7 Documentation
- 4.8 Distinction between internal and external audit
- 4.8 Responsibility for fraud and error
- 4.9 Limitations of the internal audit function

Learning focus

Internal assurance can be regarded as a key concept that underpins the whole of business assurance. As we shall see in this chapter, internal assurance relates both to the wider principles of corporate governance that we have discussed in the first two chapters of this Learning Pack and also to the role of internal audit within the context of an individual entity.

Learning outcome

In this chapter you will cover the following learning outcomes:

		Competency level
2.09	Audit procedures	3
2.09.05	Explain the importance of internal control to auditors and the execution of tests of control	
2.11	Internal audit	2
2.11.01	Explain the relationship between internal auditors and external auditors	
2.11.02	Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations	
3.05	Implications of overseas legislation such as the Sarbanes-Oxley Act 2002 on Hong Kong companies and auditors	2
3.05.01	Explain the effect of the Sarbanes-Oxley Act 2002 on Hong Kong companies and their auditors	

1 Internal control effectiveness



Topic highlights

It is the **directors** of a company who are ultimately **responsible** for ensuring that a company's **system of controls is effective**.

1.1 Importance of internal control and risk management

The role of internal controls are to:

- safeguard the company's **assets**
- help to prevent and detect **fraud**
- protect the shareholders' **investment**

Good internal control systems are designed to reduce identified risks to the business. They help deter and detect fraud. Good internal control also helps to ensure reliability of reporting, and compliance with laws.

1.2 Directors' responsibilities for internal control

The **ultimate responsibility** for a company's system of internal controls lies with the **board of directors**. A principle in the Code on Corporate Governance Practices (in Section C.2 of the Main Board Listing Rules) is that:

'The board should ensure that the issuer maintains sound and effective internal controls to safeguard the shareholders' investment and the issuer's assets.'

The board should:

- set procedures of internal control, and
- regularly monitor that the system operates effectively.

1.2.1 Setting up the internal control system

Setting up an internal control system necessitates **assessing the risks** faced by the business, so that the **system** can be **constructed** to ensure that those **risks are mitigated**.

Internal control systems will always have **inherent limitations**. No system of internal control is tight enough to eliminate totally the possibility of human error, or the chance that employees will collude in fraud to override the controls in place which might prevent the fraudulent intentions of an employee working alone.

1.2.2 Monitoring the internal control system

Once the directors have set up a system of internal control, they are also responsible for **monitoring it regularly to ensure it remains effective and is functioning appropriately**.

In order to ensure that sound and effective internal controls are maintained, Section C of the Code on Corporate Governance Practices ("the Code") states that the board should, at least annually:

- **conduct a review** of the effectiveness of the system, and
- **report to shareholders** that they have done so in the Corporate Governance Report.

(By comparison in the UK the board of directors normally **reports** on its **review of internal controls** as part of the directors' report which forms part of the annual report.)

The board may monitor the system of internal control through an **internal audit department**. Using an internal audit department should send a strong message about the board's commitment to its

governance responsibilities. An internal audit department is not essential for monitoring the system of internal control, but provision C.2.6 of the Code states that **Issuers (companies) without an internal audit function** should:

- review the need for one on an annual basis, and
- report on the outcome of this review in its Corporate Governance Report.

The annual review of the internal control system is explained in more detail below.

1.3 Annual assessment of the internal control effectiveness

There are several provisions in Section C of the Code about the annual review of the internal control system.

The Code states that the annual review should consider in particular:

- the adequacy of resources in the accounting and financial reporting function
- the qualifications and experience of the staff of the accounting and financial reporting function
- their training programmes and budget.

The report should comprise an assessment of internal controls and should confirm that the board has considered **all significant aspects** of internal control based on its identification of business risks. In particular, the annual review should consider in particular:

- (a) Any **changes** since the last **assessment** in the nature and extent of the significant **risks** faced by the company, and the company's **ability to respond to changes** in its business environment.
- (b) The **scope** and **quality** of the monitoring by management of risk and internal control, and the scope and quality of the work of the internal audit function, if such a function exists in the company.
- (c) The **extent** and **frequency** of reporting to the board (or board committee) on the results of this ongoing monitoring activity. This regular reporting enables the board or committee to build up a cumulative assessment of the state of the controls and the effectiveness of risk management.
- (d) The incidence of any **significant control failings or weaknesses** that have been identified which have a material impact on the company's financial performance or condition, or might have a material impact in the future.
- (e) The **effectiveness** of the company's **processes for compliance** with financial reporting rules and Listing Rules.

Section C of the Code also requires issuers to include, as part of their Corporate Governance Report, a narrative statement about how they have complied with the Code provisions on internal control during the reporting period. This statement should include:

- (a) the processes used by the company for identifying, evaluating and managing the risks that it faced
- (b) any additional information for understanding the company's risk management process or system of internal control
- (c) an acknowledgement that the board of the company is responsible for the system of internal control and for reviewing its effectiveness
- (d) the process used by the company to review the effectiveness of the system of internal control
- (e) the process used by the company to deal with the material internal control aspects of any serious problems that are disclosed in the annual report and accounts.

1.4 Auditors' responsibilities for internal control

The Code on Corporate Governance Practices (Appendix 14 of the Listing Rules) does not mention specifically that the auditors have a responsibility for internal control. However, in the UK guidance is given in Bulletin 2009/4.

The auditors should concentrate on the review carried out by the board. The objective of the auditors' work is to ascertain whether the entity's reporting of its internal control processes is consistent with the financial statements for the year and is supported by the documentation prepared by the directors.

The auditors should review the statement made by the board in the financial statements and the supporting documentation and make appropriate inquiries.

Auditors will have obtained some understanding of the entity's controls from their work on the financial statements; however, what they are required to do by auditing standards is narrower in its scope than the review performed by the directors. The auditors should review the statements made on internal control in the annual report to ensure that they appear true and are not in conflict with the audited financial statements.

The auditors **are not required** to consider whether the board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the company's corporate governance procedures or its risk and control procedures.

However, it is very important for auditors to communicate quickly to the directors any material deficiencies they do uncover, because of the requirements for the directors to make a statement on internal control.

The directors are required to consider the material internal control aspects of any significant problems disclosed in the financial statements. Auditors' work on this is the same as on other aspects of the statements; the auditors are not required to consider whether the internal control processes will remedy the problem.

The auditors may report by exception if problems such as the following arise:

- (a) The **board's report** of the process of review of internal control effectiveness does **not reflect the auditors' understanding** of that process
- (b) The **processes** that **deal with** material internal control aspects of **significant risk areas** do **not reflect the auditors' understanding** of those processes
- (c) The board has **not made an appropriate disclosure** if it has **failed to conduct an annual review**, or the disclosure made is not consistent with the auditors' understanding.



Self-test question 1

The Code on Corporate Governance Practices in Hong Kong ("the Code") clearly states the responsibilities of the board of directors relating to internal controls.

Required

Explain the responsibilities of the board of directors relating to internal controls in the context of principle and code provisions under the Code.

(3 marks)

HKICPA December 2012 (Amended)

(The answer is at the end of the chapter)

2 Internal audit and corporate governance



Topic highlights

Internal audit assists management in achieving the entity's corporate objectives, particularly in establishing **good corporate governance**.

2.1 Introduction

The following definition of internal auditing was given for comparison with other forms of assurance service and providers:



Key term

Internal auditing is an appraisal or monitoring activity established within an entity as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to management and the directors on the adequacy and effectiveness of components of the accounting and internal control systems.

Internal audit is generally a feature of large companies. It is a function, provided either by employees of the entity or sourced from an external organisation, to assist management in **achieving corporate objectives**. An entity's corporate objectives will vary from company to company, and will be found in a company's mission statement and strategic plan.

2.2 Internal audit and corporate governance

Established codes of corporate governance such as The Code on Corporate Governance Practices (Appendix 14) in Hong Kong and the UK's Corporate Governance Code highlight the need for boards to maintain **good systems of internal control** to manage the risks the company faces. **Internal audit** can play a key role in assessing and monitoring internal control policies and procedures.

The internal audit function can assist the board in other ways as well:

- By, in effect, acting as auditors for board reports not audited by the external auditors
- By being the experts in fields such as auditing and accounting standards in the company and assisting in implementation of new standards; and
- By liaising with external auditors, particularly where external auditors can use internal audit work and reduce the time and therefore the cost of the external audit.

Section C.3 of the Code on Corporate Governance Practices (Appendix 14 of the Listing Rules) in Hong Kong states that the key principle for Accountability and Audit is that: "The board should establish formal and transparent arrangements for considering how it will apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. The audit committee established by an issuer pursuant to the Hong Kong Stock Exchange Listing Rules should have clear terms of reference."

This implies that the board should establish **formal and transparent** arrangements for considering how they should apply the financial reporting and internal control principles for maintaining an appropriate relationship with the company's auditors.

Part of achieving this principle requires the audit committee to monitor and review the effectiveness of internal audit activities.

In addition, in order for the board to comply with the requirements of the Code where there is no internal audit function:

- The audit committee should consider annually whether there is a need for this function and make a recommendation to the board; and
- To explain in the Corporate Governance Report the absence of such a function.

The following summarises the key responsibilities of the board in relation to internal control:

- Assess the scope and effectiveness of the internal control being established by the management
- Ensure appropriate internal control in place for monitoring compliance with related laws and regulations
- Monitoring the process of internal audit
- Ensure the internal audit departments has sufficient resources and empowerment to perform their work
- Approving the appointment or dismissal of the head of internal audit
- Considering the management response to the suggestions made by the internal audit function

Role of internal audit in corporate governance

Internal audits are placed perfectly to assist management in the assessment of risks and internal controls. The UK *Internal Control: Guidance to Directors* (also known as the Turnbull Report) in particular highlights the role internal audit can have in providing objective assurance and advice on risk and control. The following summarises the key role of internal audit, which is to assist the board in practice:

- An objective evaluation of the existing risk and internal control framework
- Analysis of business processes and associated internal controls
- Reviews of existence and the value of assets
- Information on frauds and irregularities
- Ad hoc reviews on any other area for which the risk level is unacceptable
- Reviews on the financial and operational activities of the company
- Reviews of the compliance framework and specific compliance issues
- Recommendations for more effective and efficient uses of the company's resources
- Assessment on the accomplishment on the company's goals and objectives

The UK *Internal Control: Guidance to Directors* sets out some key guidelines for the board.

- Have a **defined process** for the **review** of effectiveness of **internal control**
- Review **regular** reports on **internal control**
- Consider **key risks** and how they have been **managed**
- Check the **adequacy of action taken** to remedy weaknesses and incidents
- Consider the **adequacy of monitoring**
- Conduct an **annual assessment** of risks and the effectiveness of internal control; and
- Make a **statement** on this process in the **annual report**

The traditional definition of internal audit given at the start of the section shows how internal audit can help the directors achieve these objectives; the traditional purpose of internal audit was to review controls.

The third of the above guidelines refers to risk. All companies face risks arising from their operational activities. Risks arise in different areas.

- Risk the company will go bankrupt
- Risks arising from regulations and law; and
- Risks arising from publicity

The guidelines require that risk be managed. This gives rise to another role for the internal audit function, **risk management**.

Risk awareness and management should be the role of everyone in the organisation. The extended role of internal audit with regard to risk is the monitoring of integrated risk management within a company, and the reporting of results to the board to enable them to report to shareholders.

Internal auditor relationships

Internal auditors have relationships with the following people:

- **Management:** by whom they are employed and may report to
- **Audit committee:** to whom they report; and
- **External auditors:** who may make use of their work

Reliance on the work of internal auditors by external auditors

The external auditors may make use of the work of internal audit. The guidance over when this is appropriate is given to them in HKSA 610 (Revised 2013) *Using the Work of Internal Auditors*.

The HKSA states that the external auditors must determine whether the work of the internal audit function can be used, and if so, in which areas and to what extent. If external auditors do use the work of the internal audit function, they must determine whether the work is adequate for the purposes of the audit.

In evaluating the internal audit function the following factors must be considered:

- The objectivity of the internal audit function
- Technical competence of the internal auditors
- Whether the work is likely to be carried out with due professional care
- Whether there is likely to be effective communication between the internal and external auditors
- Nature and scope of the work
- Assessed risk of material misstatement
- Degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors

We will look at HKSA 610 (Revised 2013) in detail in section 4 of this chapter.

2.3 The role of internal audit in risk management



Topic highlights

Internal audit has two key roles to play in relation to organisational risk management:

- Ensuring the company's risk management system operates effectively; and
- Ensuring that strategies implemented in respect of business risks operate effectively

The internal audit department has a two-fold role in relation to risk management.

- It monitors **the company's overall risk management policy** to ensure it operates effectively; and
- It monitors the **strategies** implemented to ensure that they continue to operate effectively.

A significant risk management policy in companies is to implement internal controls, and here internal audit has a key role in assessing systems and testing controls.

Internal audit may assist in the development of systems. However, its key role will be in **monitoring the overall process** and in **providing assurance** that the **systems** which the departments have designed **meet objectives** and **operate effectively**.

HKSA
610.13

It is important that the internal audit department retains its **objectivity** towards these aspects of its role, which is another reason why internal audit would generally not be involved in the assessment of risks and the design of the system.

The UK guidance and internal audit's role in relation to risk management was touched on. In response to this, directors need to ensure three steps are taken in their business.

- Identify risks
- Control risks
- Monitor risks

It is not internal audit's primary role to manage risk in a company. It is the responsibility of the directors, usually delegated to individual managers in various departments.

The risks are identified and assessed, and a policy is taken in respect of each of them. This policy is usually one of four:

- Accept risk (if it is low impact and likelihood)
- Reduce risk (by setting up a system of internal control)
- Avoid risk (by not entering market, accepting contract etc); and
- Transfer risk (by taking out insurance)

With their skills in business systems, internal auditors are ideally placed to **monitor** this process and add value to it. They can:

- give advice on the best design of systems and monitor their operation
- be involved in a process that continually improves internal control systems; and
- provide assurance on systems set up in each department

The involvement of internal audit as a monitoring unit will help to ensure that the process of risk identification and management in a business is a **continual process** rather than a one-off exercise.

2.4 Outsourcing the internal audit function



Topic highlights

Internal audit departments may consist of employees of the company, or may be **outsourced** to external service providers. The **advantages** of outsourcing the internal audit function include speed, cost and a tailored answer to internal audit requirements. One of the main **disadvantages** may include threats to independence and objectivity if the external audit service is provided by the same firm.

2.4.1 What is outsourcing?



Key term

Outsourcing is the use of external suppliers as a source of finished products, components or services. It is also known as sub-contracting.

While the scope of the internal auditor's work is different to that of the external auditor, there are many features that can link them. One of the key factors is that the **techniques** which are used to carry out audits are the same for internal and external auditors.

It can be expensive to maintain an internal audit function consisting of employees of the company. It is possible that the **monitoring and review** required by a certain company could be done in a small amount of time and full-time employees cannot be justified.

It is also possible that a number of internal audit staff are required, but the cost of recruitment is prohibitive, or the directors are aware that the need for internal audit is only short-term.

In such circumstances, it is possible to **outsource** the internal audit function, that is, purchase the service from outside.

In this respect, many of the larger accountancy firms offer internal audit services. It is likely that the same firm might offer one client both internal and external audit services. In such circumstances the firm would have to be aware of the **independence issues** this would raise for the external engagement team and **implement safeguards** to ensure that its independence and objectivity were not impaired.

2.4.2 Advantages and disadvantages of outsourcing

The advantages and disadvantages of outsourcing the internal audit function are set out in the following table:

Advantages of outsourcing	Disadvantages of outsourcing
<ul style="list-style-type: none"> • Staff do not need to be recruited, as the service provider has good quality staff. • The service provider has different specialist skills and can assess what management require them to do. • Outsourcing can provide an immediate internal audit department. • Associated costs, such as staff training, are eliminated. • The service contract can be for the appropriate time scale. • Because the time scale is flexible, a team of staff can be provided if required. • It can be used on a short-term basis or on a “as needed basis”. 	<ul style="list-style-type: none"> • There will be independence and objectivity issues if the company uses the same firm to provide both internal and external audit services. • The cost of outsourcing the internal audit function might be high enough to make the directors choose not to have an internal audit function at all. • Company staff may oppose outsourcing if it results in redundancies. • There may be a high staff turnover of internal audit staff. • The outsourced staff may only have a limited knowledge of the company. • The company will lose existing or developing in-house skills.

2.5 Managing an outsourced department

A company will need to establish **controls** over the outsourced internal audit department. These would include the following:

- Setting **performance measures** in terms of cost and areas of the business reviewed and investigating any variances
- Ensuring appropriate **audit methodology** (working papers/reviews) is maintained
- Reviewing** working papers on a sample basis to ensure they meet internal standards/guidelines
- Agreeing** internal audit work plans in advance of work being performed
- If external auditor is used, ensuring the firm has suitable controls to keep the two functions separate so that **independence and objectivity** is not impaired

3 Sarbanes-Oxley Act 2002



Topic highlights

The **Sarbanes-Oxley legislation** requires directors to **report on the effectiveness of the controls over financial reporting, limits the services auditors can provide** and requires listed companies to establish an **audit committee**. It adopts a **rules-based** approach to governance.

3.1 The Enron scandal

The most **significant scandal** in America in recent years has been the Enron scandal, when one of the country's biggest companies filed for bankruptcy. The scandal also resulted in the disappearance of Arthur Andersen, one of the Big Five accountancy firms who had audited Enron's financial statements. The main reasons why Enron collapsed were over-expansion in energy markets, eventually too much reliance on derivatives trading which eventually went wrong, breaches of federal law, and misleading and dishonest behaviour. Inquiries into the scandal exposed a number of weaknesses in the company's governance structure.

The following case study describes the details of the scandal:



Case study

The Enron case is perhaps the best-known failure of a large American corporation.

Enron Corporation was an energy company based in Houston, Texas. At its peak it was one of the world's largest producers of electricity and gas as well as having large-scale pulp, paper and communications businesses. At the time it filed for Chapter 11 bankruptcy (protection from creditors' claims under US law) in 2001, Enron employed over 20,000 personnel. By the end of that year, it had been revealed that Enron had been used as a vehicle for systematic accounting fraud, with its major executives directly involved in the criminal activities.

Prior to the disaster, Enron had been highly successful and reputable. It had been voted America's most innovative company on several occasions. The company's business model was one of integration and diversification. In addition to marketing energy, Enron actually built the pipelines and power plants (backward integration). To spread its risks beyond the energy industry, it moved successfully into telecommunications and e-commerce as well as trading derivatives.

Once the problems were uncovered, it emerged that Enron's financial statements were completely misleading. Its recorded assets were inflated in value and in some cases non-existent. The company had placed debts and other obligations with offshore entities, thereby not consolidating them in the group financial statements.

The systematic false accounting that had taken place led to a criminal investigation and the arrest and indictment of several senior figures in the company. Several of the directors paid significant sums of money to settle law suits against them. Jeffrey Skilling, the former Chief Executive Officer, was sentenced to 24 years in prison on numerous charges, including fraud.

The ramifications of the Enron case were not confined to the company. Serious questions were raised about the failure of Arthur Andersen, the external auditors of the company, to identify the inconsistencies in the Enron financial statements. This led to the subsequent break up and dissolution of the accounting firm.

Enron's successor company, Enron Creditors Recovery Corporation, survives today with less than 500 personnel.

The Enron scandal, together with other high profile corporate failures, led to a reappraisal of standards of corporate governance in the USA and further afield. The Enron case was the prime mover for the introduction in 2002 of the Sarbanes-Oxley Act in the USA, which established a

Public Company Accounting Oversight Board (“PCAOB”) to oversee the **auditors of public companies**. Its stated purpose is to “protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports”. The formation of the PCAOB greatly reinforced the laws on senior executive accountability. The Act also influenced the stock exchanges of many countries and accelerated the creation of codes of practice to which all listed companies are now expected to adhere.

3.1.1 Lack of transparency in the financial statements

This particularly related to certain investment vehicles that were kept **off balance sheet**. Various other methods of inflating revenues, offloading debt, massaging quarterly figures and avoiding taxes were employed.

3.1.2 Inadequate scrutiny by the external auditors

Arthur Andersen **failed to spot or failed to question** dubious accounting treatments. Since Andersen's consultancy arm did a lot of work for Enron, there were allegations of conflicts of interest.

3.1.3 Information asymmetry

That is the agency problem of the directors/managers knowing more than the investors. The investors included Enron's employees. Many had their personal wealth tied up in Enron shares, which ended up being worthless. They were actively discouraged from selling them. Many of Enron's directors, however, sold the shares when they began to fall, potentially profiting from them. It is alleged that the Chief Financial Officer of Enron, concealed the gains he made from his involvement with affiliated companies.

3.1.4 Executive compensation methods

These were meant to align the interests of shareholders and directors, but seemed to encourage the overstatement of short-term profits. Particularly in the USA, where the tenure of Chief Executive Officers is fairly short, the temptation is strong to inflate profits in the hope that share options will have been cashed in by the time the problems are discovered.

3.2 The Sarbanes-Oxley Act 2002

3.2.1 The history of the Sarbanes-Oxley Act 2002

The Oxley Bill, composed by Representative Michael Oxley, was passed in April 2002, which was related to the accountability, responsibility and transparency of stating financial status of the company. At the same time Senator Paul Sarbanes had another proposal on the similar lines. He presented the bill to the Senate Banking Committee which passed the Bill with a majority.

Thereafter both the proposals made by House Representative Oxley and Senator Paul Sarbanes were reconciled to be formed into one Act, which is now popularly known as the **Sarbanes-Oxley Act**.

Sarbanes-Oxley came into force mainly due to the **financial scandals** committed by corporate giants like **Enron, WorldCom**, etc, showing inadequacies in corporate government arrangements causing breakdown of stock market trust. Since then the Sarbanes-Oxley Act has been the most important piece of legislation to seriously affect the corporate governance, financial disclosures and total accounting practice in companies.

Most companies focus their attention on Sarbanes-Oxley work in 13 specific areas. These 13 areas are the ones where most of the financial impact is felt. Section 404 of the Sarbanes-Oxley Act is the one that has caused most concern in the financial sector as it requires the corporate body to enforce stricter controls over financial reporting by internal accounting personnel.

3.2.2 Application of the Sarbanes-Oxley Act

It has now become **mandatory** for US listed companies to have Sarbanes-Oxley compliance, and to meet Sarbanes-Oxley compliance deadlines. Sarbanes-Oxley states that smaller companies and foreign companies should meet the mandates for statements filed.

The Act applies to all companies that are required to file periodic reports with the Securities and Exchange Commission (SEC). The Act was the most far-reaching US legislation dealing with securities in many years and has major implications for public companies. Rule-making authority was delegated to the SEC on many provisions.

Sarbanes-Oxley shifts responsibility for financial probity and accuracy to the board's **audit committee**, which typically comprises three independent directors, one of whom has to meet certain financial literacy requirements (equivalent to non-executive directors in other jurisdictions).

Along with rules from the Securities and Exchange Commission, Sarbanes-Oxley requires companies to increase their financial statement **disclosures**, to have an internal **code of ethics** and to impose **restrictions on share trading** by, and **loans to**, corporate officers.

3.3 Detailed provisions of the Sarbanes-Oxley Act

3.3.1 Public Oversight Board

The Act set up a new regulator, **The Public Company Accounting Oversight Board (PCAOB)**, to oversee the audit of public companies that are subject to the securities laws.

The Board has powers to set **auditing, quality control, independence and ethical standards** for registered public accounting firms to use in the preparation and issue of audit reports on the financial statements of listed companies. In particular, the Board is required to set standards for registered public accounting firms' reports on listed company statements on their internal control over financial reporting. The Board also has **inspection and disciplinary powers** over firms.

The **Public Company Accounting Oversight Board (PCAOB)** has powers include setting auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports by issuers. It also has the authority to regulate the non-audit services that audit firms can offer.

3.3.2 Auditing standards

Audit firms should **retain working papers** for at least seven years, and have **quality control standards** in place such as second partner review. As part of the audit they should review internal control systems to ensure that they **reflect the transactions** of the client and provide **reasonable assurance** that the transactions are recorded in a manner that will **permit preparation** of the **financial statements** in accordance with **generally accepted accounting principles**. They should also review records to check whether **receipts** and **payments** are being made **only in accordance with management's authorisation**.

3.3.3 Non-audit services

Auditors are expressly prohibited from carrying out a number of services including internal audit, bookkeeping, systems design and implementation, appraisal or valuation services, actuarial services, management functions and human resources, investment management, legal and expert services. **Provision of other non-audit services** is only allowed with the **prior approval** of the **audit committee**.

3.3.4 Quality control procedures

There should be **rotation** of lead or reviewing audit partners every five years and other procedures such as independence requirements, consultation, supervision, professional development, internal quality review and engagement acceptance and continuation.

3.3.5 Auditors and audit committee

Auditors should discuss **critical accounting policies, possible alternative treatments**, the management letter and unadjusted differences with the audit committee.

3.3.6 Audit committees

Audit committees should be established by all listed companies.

All members of audit committees should be **independent** and should therefore not accept any **consulting or advisory fee** from the company or be affiliated to it. At least one member should be a financial expert. Audit committees should be responsible for the **appointment, compensation** and **oversight** of auditors. Audit committees should establish mechanisms for dealing with complaints about accounting, internal controls and audit.

3.3.7 Corporate responsibility

The Chief Executive Officer and Chief Finance Officer should certify the appropriateness of the financial statements and that those financial statements fairly present the operations and financial condition of the issuer. If the company has to prepare a restatement of financial statements due to material non-compliance with standards, the Chief Finance Officer and Chief Executive Officer should forfeit their bonuses.

3.3.8 Off-balance sheet transactions

There should be **appropriate disclosure of material off-balance sheet transactions** and other relationships (transactions that are not included in the financial statements but that impact upon financial conditions, results, liquidity or capital resources).

3.3.9 Internal control reporting

Annual reports should contain **internal control reports** that state the responsibility of management for establishing and maintaining an **adequate internal control structure and procedures for financial reporting**. Annual reports should also contain an **assessment** of the **effectiveness** of the **internal control structure and procedures for financial reporting**. Auditors should report on this assessment.

Companies should also report whether they have adopted a **code of conduct** for senior financial officers and the content of that code.

3.3.10 Whistleblowing provisions

Employees of listed companies and auditors will be granted whistleblower protection against their employers if they **disclose private employer information** to parties involved in a fraud claim.

3.4 Impact of Sarbanes-Oxley in America

After the Sarbanes-Oxley Act came into force, accounting systems and financial statements disclosed by the companies made tremendous progress. This improvement has been possible due to rigorous requirements stated in the Sarbanes-Oxley Act, which helps to **protect investor confidence** in companies and the US legislature as well. Moreover, it also helps in establishing a Public Company Accounting Oversight Board, auditor independence, corporate responsibility and enhanced financial disclosures.

The biggest expense as a result of compliance that companies are incurring is fulfilling the requirement to ensure their **internal controls** are properly documented and tested. US companies had to have efficient controls in the past, but they are now having to **document** them more comprehensively than before, and then have the external auditors report on what they have done.

The Act also formally stripped accountancy firms of almost all non-audit revenue streams that they used to derive from their audit clients, for fear of conflicts of interest.

For lawyers, the Act strengthens requirements on them to whistleblow internally on any wrongdoing they uncover at client companies, right up to board level.

3.5 International impact of Sarbanes-Oxley

The Act also has a significant **international dimension**. About 1,500 non-US companies, including many of the world's largest, list their shares in the US and are covered by Sarbanes-Oxley. There were complaints that the new legislation conflicted with local corporate governance customs, and following an intense round of lobbying from outside the US, changes to the rules were secured.

As America wields such significant influence worldwide, arguably Sarbanes-Oxley may influence certain jurisdictions to adopt a more rules-based approach.

3.6 Impact of Sarbanes-Oxley in Hong Kong

There are a number of companies listed on both the Hong Kong Stock Exchange and the New York Stock Exchange, these companies are subject to applicable Hong Kong laws and regulations, including the Hong Kong Listing Rules, the Hong Kong Companies Ordinance, as well as applicable US federal securities laws, including the US Securities Exchange Act of 1934, as amended, and the Sarbanes-Oxley Act. In addition, these companies are subject to the listing standards of the New York Stock Exchange to the extent they apply to non-US issuers. As a non-US issuer, these companies are not required to comply with all of the corporate governance listing standards of the New York Stock Exchange.

However, the Act has marked a new era in the Hong Kong regulatory regime which is commensurate with international securities regulatory standards starting in 2003. Consequently, Hong Kong and London are the places where companies are finding it easier and cheaper to list their shares and raise capital.

3.7 Criticisms of Sarbanes-Oxley

Many commentators have criticised Sarbanes-Oxley for **not being strong enough** on some issues, for example the selection of external auditors by the audit committee, and at the same time being over-rigid on others. Directors may be less likely to consult lawyers in the first place if they believe that legislation could override lawyer-client privilege.

In addition, they allege a Sarbanes-Oxley compliance industry has sprung up focusing companies' attention on complying with all aspects of the legislation, significant or much less important. This has distracted companies from **improving information flows** to the market and then allowing the market to make well-informed decisions. The Act has also done little to address the temptation provided by generous stock options to inflate profits, other than requiring possible forfeiture if financial statements are subsequently restated.

Most significantly perhaps there is recent evidence of companies turning away from the US stock markets and towards other markets such as London and Hong Kong. The number of initial public listings fell in New York after the introduction of Sarbanes-Oxley and rose in stock exchanges allowing a more flexible, principles-based, approach. An article in the *Financial Times* suggested that this was partly due to companies tiring of the **increased compliance costs** associated with Sarbanes-Oxley implementation.

In particular, directors of smaller listed companies have been unhappy with the requirement for companies to report on the effectiveness of their internal control structure and procedures for financial reporting. They have argued that gathering sufficient evidence for auditors on the internal controls over financial reporting is expensive and less important for small companies than for large ones.

In addition, the nature of the **regulatory regime** may be an increasingly significant factor in listing decisions. A rules-based approach means compliance must be absolute; the comply or explain choice is not available.

4 Internal auditors



Topic highlights

External auditors may make use of the work of an **internal audit** department when carrying out audit procedures.

4.1 Using the work of internal auditors

HKSA 610.
13-24

Although the responsibilities of internal and external auditors are different (we explore how in the paragraphs that follow), the external auditor may be able to make use of the work of internal auditors in forming an opinion. Often the respective roles employ the same techniques but to different ends. HKSA 610 (Revised 2013) *Using the Work of Internal Auditors* requires that external auditors should take into account the internal audit function when planning their audit, but bear in mind that internal auditors work for management and those charged with governance so they are not independent. Therefore, the external auditors hold sole responsibility for the audit opinion expressed on the financial statements. The standard was revised in December 2012 with changes effective for audits of financial statements for periods ending on or after 15 December 2013. The standard was then revised again in May 2013 with additional provisions added where internal auditors are used to provide direct assistance. These additional provisions are effective for audits of financial statements for periods ending on or after 15 December 2014.

4.2 Relationship between HKSA 315 (Revised) and HKSA 610 (Revised 2013)

HKSA 315 (Revised) addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment, as well as the identification and assessment of risks of material misstatement. HKSA 315 (Revised) also explains how effective communication between the internal and external auditors creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.

HKSA 610 (Revised 2013) addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function, obtained as a result of procedures performed under HKSA 315 (Revised), the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained.

The External Auditor's Responsibility for the Audit

The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function on the engagement.

4.3 Internal audit function

The term "internal auditors" is now changed to "internal audit function".



Key term

Internal audit function. A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

4.3.1 Objectives and scope of internal functions

The objectives and scope of the internal audit function typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control, such as the following:

- Activities relating to governance
- Activities relating to risk management
- Activities relating to internal control

Performance of activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity.

While the objectives of the entity's internal audit function and the external auditor differ, the internal audit function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements.

4.4 Evaluating the internal audit function

The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

- (a) The extent to which the internal audit function's **organisational status and relevant policies and procedures** support the **objectivity** of the internal auditors;

The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for the purposes of the audit, and the **nature and extent** to which the work of the internal audit function can be used in the circumstances.

Objectivity refers to the ability to perform those tasks **without allowing bias, conflict of interest or undue influence** of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:

- Whether the **organisational status** of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments, e.g. whether the internal audit function **reports** to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
 - Whether the internal audit function is **free of any conflicting responsibilities** e.g. having managerial or operational responsibilities outside the internal audit function.
 - Whether **those charged with governance oversee employment decisions** related to the internal audit function, e.g. determining the appropriate remuneration policy.
 - Whether there are **any constraints or restrictions placed on the internal audit function** by management or those charged with governance e.g. in communicating findings to the external auditor.
 - Whether the internal auditors are **members of relevant professional bodies** and their memberships obligate their compliance with relevant professional standards relating to objectivity.
- (b) **The level of competence of the internal audit function;**
- Whether the internal audit function is **adequately and appropriately resourced** relative to the size of the entity and the nature of its operations.
 - Whether there are **established policies** for hiring, training and assigning internal auditors to internal audit engagements.

- Whether the internal auditors have **adequate technical training** and proficiency in auditing.
 - Whether the internal auditors possess the **required knowledge relating to the entity's financial reporting**.
 - Whether the internal auditors are **members of relevant professional bodies** that oblige them to comply with the relevant professional standards including continuing professional development requirements.
- (c) Whether the internal audit function applies a **systematic and disciplined approach, including quality control**.

Factors that may affect the external auditor's determination of whether the internal audit function applies a **systematic and disciplined approach** include the following:

- The existence, adequacy and use of documented **internal audit procedures or guidance** covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.
- Whether the internal audit function has **appropriate quality control policies and procedures**, for example, such as those policies and procedures in HKSQC 1 (Clarified) that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors.

4.4.1 Determining the nature and extent of work that can be used

The external auditor considers the nature and scope of the work that has been performed or is planned to be performed by the internal audit function and assesses its relevance to the overall strategy and plan for the external audit.

The external audit must make all significant judgments in relation to the audit and must prevent undue use of the work of the internal auditor by performing more of the work directly. Examples of internal audit work that might be used by the external auditor include:

- Testing of the operating effectiveness of controls
- Substantive procedures involving limited judgment
- Observations of inventory controls
- Tracing transactions through the information system relevant to financial reporting
- Testing of compliance with regulatory requirements

4.5 Using the work of the internal audit function

If the external auditor plans to use the work of the internal audit function, the external auditor shall **discuss the planned use of its work** with the function as a basis for coordinating their respective activities.

(a) **Discussion and coordination with the internal audit function**

In **discussing** the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work
- The nature of the work performed
- The extent of audit coverage
- Materiality for the financial statements as a whole and performance materiality

- Proposed methods of item selection and sample sizes
- Documentation of the work performed
- Review and reporting procedures

Coordination between the external auditor and the internal audit function is effective when, for example:

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.
- The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

(b) **Adequacy of the work of internal auditors**

The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its **adequacy for purposes of the audit**, including evaluating whether:

- The work of the function had been properly planned, performed, supervised, reviewed and documented;
- Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and
- Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed.

The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function include:

- Making inquiries of appropriate individuals within the internal audit function
- Observing procedures performed by the internal audit function
- Reviewing the internal audit function's work program and working papers

(c) **Nature and extent of the external auditor's audit procedures**

The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:

- The amount of judgment involved;
- The assessed risk of material misstatement;
- The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors; and
- The level of competence of the function. This shall include reperformance of some of the work. Reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of internal audit as compared to other procedures.

The requirement to reperform some of the internal audit work is a new requirement included in the revised HKSA.

HKSA
610.26-35

4.6 Using internal auditors to provide direct assistance

HKSA 610 (Revised 2013) now includes guidance for situations where the external auditor uses the internal auditors to provide direct assistance.



Key term

Direct assistance. The use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor

4.6.1 Determining whether internal auditors can be used to provide direct assistance

If the external auditor wishes to use the internal audit function to provide direct assistance, and this is not prohibited by law or regulation the external auditor is required to evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors. In making this assessment the external auditor will consider the following:

- The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors
- Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates
- Association with the division or department in the entity to which the work relates
- Significant financial interests in the entity (other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority)

HKSA 610 (Revised 2013) also specifies instances where use of internal auditors to provide direct assistance is prohibited:

- Where there are significant threats to the objectivity of the internal auditor
- Where the internal auditor lacks sufficient competence to perform the proposed work

4.6.2 Nature and extent of work that can be assigned

When determining the nature and extent of the work that can be assigned to the internal auditors the external auditor must consider:

- The amount of judgment involved in planning and performing the procedures and evaluating the evidence gathered
- The assessed risk of material misstatement and
- The external auditor's evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors

HKSA 610 (Revised 2013) prohibits the use of internal auditors to provide direct assistance to perform the following procedures:

- (a) Those that involve making significant judgments in the audit
- (b) Those that relate to work with which the internal auditors have been involved and which has been/will be reported to management/those charged with governance
- (c) Those that relate to decisions the external auditor makes regarding the internal audit function and the use of its work or direct assistance

It would not be appropriate for the internal auditors to provide direct assistance in respect of the following:

- Discussion of fraud
- Determination of unannounced audit procedures in accordance with HKSA 240
- Responsibilities regarding external confirmation requests and evaluation of results of external confirmation procedures

The HKSA also makes the point that excessive use of internal auditors to provide direct assistance may affect perceptions regarding the independence of the external audit.

4.6.3 Using internal auditors to provide direct assistance

Before using the internal auditors to provide direct assistance the external auditor is required to obtain written agreement from the entity that the internal auditors will be allowed to follow instruction from the external auditor. Written agreement from the internal auditors that they will keep information confidential must also be obtained. The external auditor is then responsible for ensuring that the internal auditors' work is properly directed, supervised and reviewed.

HKSA
610.36-37

4.7 Documentation

If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

- The **evaluation** of:
 - Whether the function's organisational status and relevant policies and procedures adequately support the objectivity of the internal auditors;
 - The level of competence of the function; and
 - Whether the function applies a systematic and disciplined approach, including quality control;
- The **nature and extent** of the work used and the basis for that decision; and
- The audit procedures performed by the external auditor to evaluate the **adequacy** of the work used.

If the internal auditors provide direct assistance the external auditors must document the following:

- The evaluation of the existence and significance of threats to objectivity
- The basis for the decision regarding the nature and extent of the work performed by the internal auditors
- Who reviewed the work performed and the date and extent of that review
- The written agreements required (see section 4.6.3 above)
- The working papers prepared by the internal auditors



Self-test question 2

As the external auditors for Union Bank, you are considering relying on the work of the internal audit functions for testing the internal control. The internal audit function is part of the accounting and finance division and reports to the Chief Financial Officer.

Being the audit senior, you have been assigned to review the work of internal auditors prior to the commencement of this year's audit. The following issues are discovered:

- (1) For most of the audit tests, there is no detailed documentation of the work by the internal auditors that has been completed.

- (2) There is a high staff turnover within the internal audit department. There are five staff in the department responsible to undertake internal control testing. The new staff employed have no audit and accounting experience.
- (3) Union Bank's audit plan and programme are developed based on the firm's standard audit plan. However, the testing of wages is not selected. Upon discussion with the internal auditors, the auditors reveal that the financial controller has altered the instructions as he recognises that the risk of non-compliance in the wages area is minimal.
- (4) For those areas that have been documented, the results are quite clear and competently completed. However, three compliance errors are detected in the loan approvals and there are no follow up procedures, as the entity believes these incidents are immaterial.

Required

Demonstrate the weaknesses in the internal audit department and your consideration whether you consider the audit firm should rely on Union Bank's internal audit function.

(The answer is at the end of the chapter)

4.7 Distinction between internal and external audit



Topic highlights

Although many of the techniques internal and external auditors use may be similar, the basis and reasoning of their work is different.

The **external audit** is focused on the **financial statements**, whereas the **internal audit function** is focused on the **operations of the entire business**.

The following table highlights the differences between internal and external audit:

	Internal audit	External audit
Objective	Designed to add value and improve an entity's operations.	An exercise to enable auditors to express an opinion on the financial statements.
Reporting	Reports to the board of directors, or other people charged with governance, such as the audit committee. Reports are private and for the directors and management of the entity.	Reports to the shareholders or members of an entity on the truth and fairness of the financial statements. Audit report is publicly available to the shareholders and other interested parties.
Scope	Work relates to the operations of the entity.	Work relates to the financial statements.
Relationship	Often employees of the organisation, although sometimes the function is outsourced.	Independent of the entity and its management. Usually appointed by the shareholders.

The table demonstrates that the **whole basis and reasoning** of internal audit work is **fundamentally different** to that of external audit work.

4.8 Responsibility for fraud and error



Topic highlights

It is the responsibility of management and those charged with governance to prevent and detect fraud, and in this respect, the internal audit function may have a role to play.

Fraud is a **significant business risk**. It is the responsibility of the **directors** to prevent and detect fraud. However, as the internal audit function plays an important role in the management of risk so it is by implication involved in the process of managing the risk of fraud. It is *not* the responsibility of the external auditors to prevent and detect fraud, although they may uncover fraud while carrying out their audit of the financial statements, which will be undertaken with the possibility of material misstatement through fraud in mind. We will study the external auditor's responsibilities for the detection of fraud and error in more detail in Chapter 10.

The internal audit function can help to **prevent** fraud by carrying out timely reviews on **the adequacy and effectiveness of control systems** and making appropriate recommendations. The internal audit function may be able to **detect** fraud by **being mindful** to the possibility when carrying out its work and **reporting any suspicions**.

Establishing **an internal audit department and investing it with appropriate authority and stature** may act as a powerful **deterrent** to fraud in itself. Management may require the internal auditors to undertake **special projects** to investigate any reported suspicions.

4.9 Limitations of the internal audit function

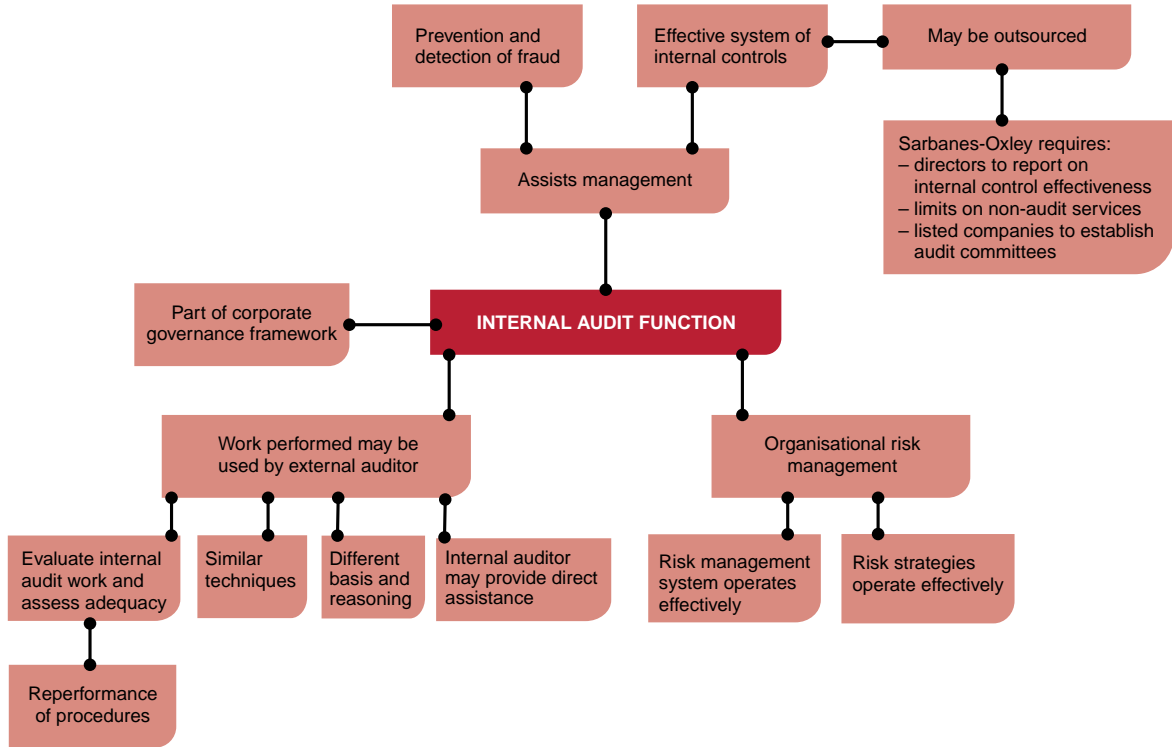
Although the presence of an internal audit department within an entity is indicative of good internal control, by its very nature, there are some **limitations** of the internal audit function.

Internal auditors are employed by the entity and this can **impair their independence and objectivity** and ability to report fraud/error to senior management because of perceived threats to their continued employment within the entity.

To ensure transparency, best practice indicates that the internal audit function should have a **dual reporting relationship**, i.e. report both to management and those charged with governance (the audit committee). If this reporting structure is not in place, management may be able to unduly influence the internal audit plan, scope, and whether issues are reported appropriately. This results in serious potential conflict, and limits the scope and compromises the effectiveness of the internal audit function.

Internal auditors are not required to be **professionally qualified** (as accountants are) and so there may be limitations in their knowledge and technical expertise.

Topic recap



Answer to self-test question

Answer 1

The general principle of the Code on Corporate Governance Practices (“the Code”) in Hong Kong requires the board of directors to maintain a sound and effective system of internal control to safeguard the shareholder’s investment and the company’s assets.

In Section C of the Code, the board is required to conduct a review of the effectiveness of the company’s system of internal controls and report to the shareholders that they have done so in their Corporate Governance Report at least annually.

The review should cover all material controls, including financial, operational and compliance controls and risk management functions; and consider the adequacy of resources, qualifications and experience of staff of the company’s accounting and financial reporting functions, and their training programmes and budget.

Answer 2

The weaknesses in the internal audit department may be identified as follows:

- (1) The new staff are not competent and do not have any professional qualifications or accounting experience. More competent staff should be engaged.
- (2) The internal audit function reporting to the chief financial officer is not an independent act. The internal auditors should report to the highest level of management such as the board or the audit committee.
- (3) There is no documentation of work performed and this is inadequate. Proper documentation should be in place.
- (4) Errors in the compliance tests have not been followed up and this shows lack of competence and professional due care.
- (5) The audit programme has been altered by the Financial Controller. Internal auditors should not be influenced by any other management person.

Under HKSA 610 (Revised 2013), external auditors should consider the following before relying on the work of the internal audit function:

- The extent to which the internal audit function’s organisational status and relevant policies and procedures support the objectivity of the internal auditors
- The level of competence of the internal audit function
- Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Overall, it seems that it is not desirable to rely on internal auditing work.

Exam practice

**Stone Company Limited****23 minutes**

You are the audit manager of a CPA firm and are responsible for the audit of Stone Company Limited ("Stone") for the year ended 31 December 20X3. The Chief Finance Officer of Stone, Mr Chan, has informed you that at the beginning of the year the company set up an internal audit department. He has asked you to use extensively Stone's internal audit department resources for the purpose of carrying out the forthcoming audit. In particular, Mr Chan has suggested you rely on the internal auditors for the following audit procedures:

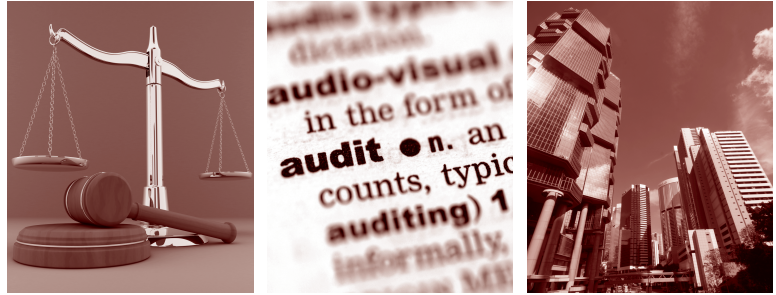
- (a) Attendance of year-end inventory count
- (b) Determining the sample sizes; and selecting and arranging confirmation of the company's receivables balances.

At 31 December 20X3, the inventory and receivables balances were approximately 25% and 30% of the company's total assets, respectively. The head of the internal audit department will report to you directly the findings of the year-end inventory count and the results of the confirmation.

Required

- (a) If you plan to use the internal auditor's work, how would you assess Stone's internal audit function before deciding to use their work? **(7 marks)**
- (b) Explain whether you would use the work of Stone's internal auditors in the specific ways suggested by Mr Chan. **(8 marks)**

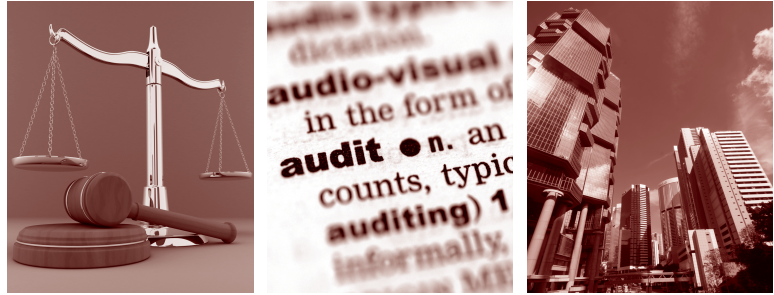
(Total = 15 marks)**HKICPA February 2004 (amended)**



Part C

Professional standards and guidance

Professional standards and guidance are a must to have a job done properly in any accountancy and auditing engagement. The practice of arbitrary techniques and scandals developed from creative procedures are damaging the accountancy profession. Students are expected to learn the Code of Ethics by heart and become a CPA of the highest calibre. They are then more ready to face ethical dilemmas and carry out their responsibilities in a creditable way.



chapter 4

Code of Ethics

Topic list

- 1 Fundamental principles and the conceptual framework approach**
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Learning focus

Professional accountants are sometimes faced by ethical dilemmas. Codes of ethics, such as that issued by the Hong Kong Institute of Certified Public Accountants, give guiding principles to help professional accountants carry out their responsibilities to both their profession and the wider public.

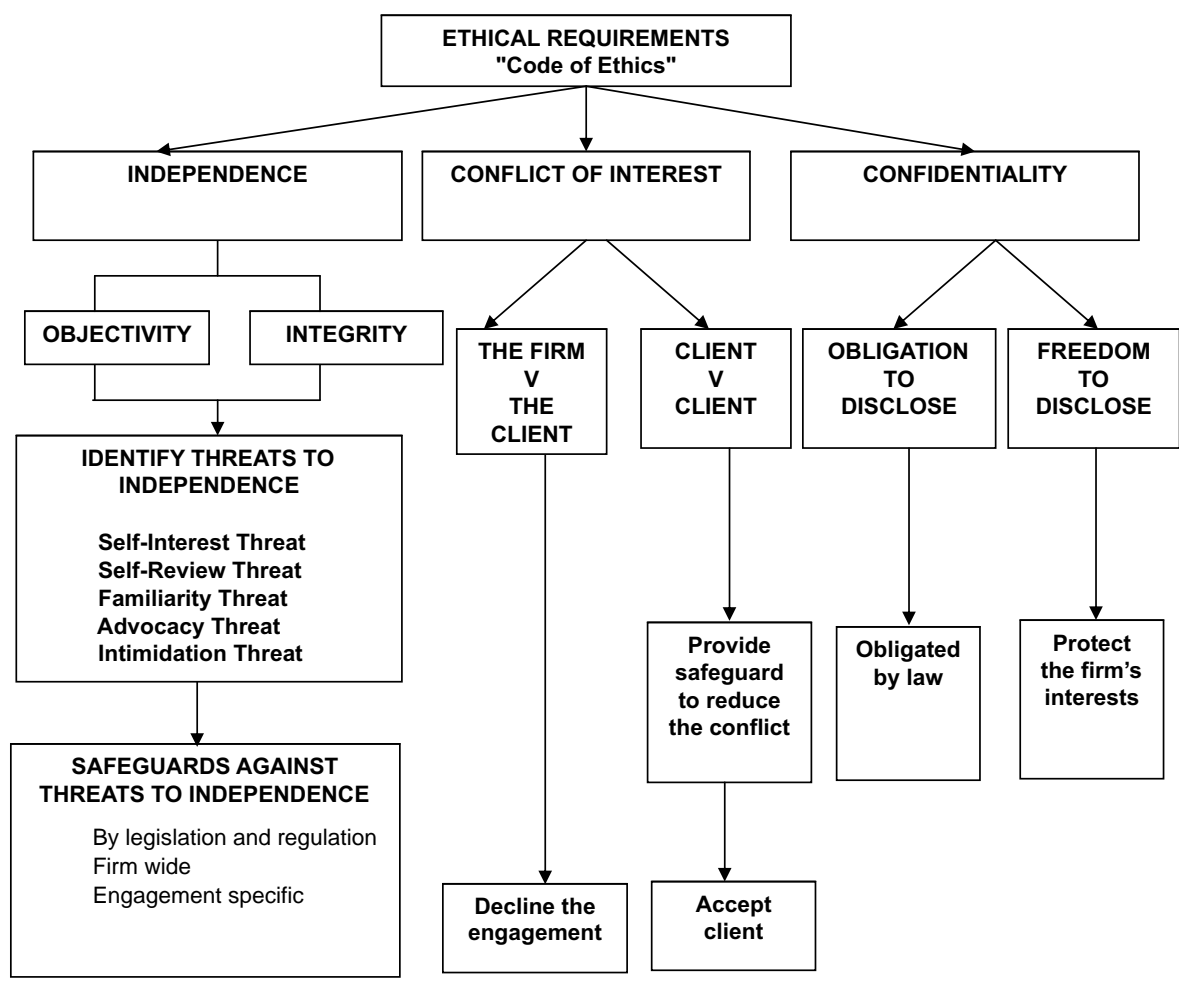
There are also a number of practical measures (safeguards) that a firm may implement to ensure that these ethical principles are not breached.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
1.01	The Institute's Code of Ethics for Professional Accountants	3
1.01.01	Explain the fundamental principles and the conceptual framework approach	
1.01.02	Identify, evaluate and respond to threats to compliance with the fundamental principles	
1.01.03	Discuss and evaluate the effectiveness of available safeguards	
1.01.04	Recognise and advise on conflicts in the application of fundamental principles for Professional Accountants in practice and in business	

The following summary illustrates the main parts of the chapter:



It is important that you understand the topic well. Auditors are subject to ethical requirements imposed by the accountancy bodies; in Hong Kong, it is the HKICPA.

Code of Ethics for Professional Accountants Revised June 2010; February 2012

This Code of Ethics for Professional Accountants (the *Code*) is effective on 1 January 2011. It replaces the version issued in December 2005 which is effective from 30 June 2006 until 31 December 2010.

All Professional Accountants are required to comply with the Code.

- Section A – **GENERAL APPLICATION OF THE CODE**
- Section B – **PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE**
- Section C – **PROFESSIONAL ACCOUNTANTS IN BUSINESS**
- Section D – **ADDITIONAL ETHICAL REQUIREMENTS**
- Section E – **SPECIALISED AREAS OF PRACTICE**

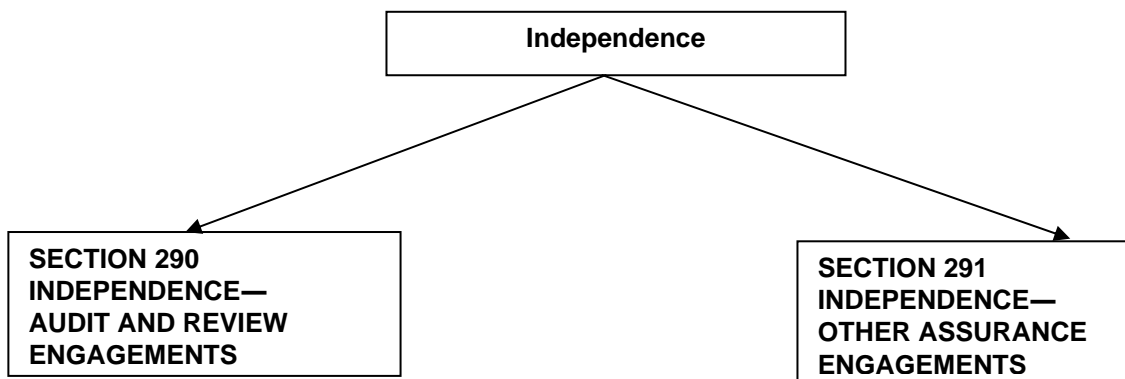
	<i>Professional Accountant in Public Practice</i>	<i>Professional Accountant in Business</i>
Definition:	Professional accountant in a firm that provides professional services	Professional accountant employed or engaged in an executive or non-executive capacity ie commerce, industry, service etc
Adoption of which Parts of the Code:	A,B,D,E of the Code	A,C D,E of the Code

SUMMARY OF THE MAIN CHANGES IN THE Code

The *Code of Ethics* has been revised so that it is more consistent with the Clarity project in order to make the *Code* clearer to users:

The following are the main changes in the *Code*:

- (i) The threat to independence should be **reduced to an acceptable level**.
- (ii) The threats to independence have been given revised descriptions and examples.
- (a) **The Structure of the Code has been changed by dividing it into two parts:**



- (b) **“Listed Entities” versus “Public Interest Entities”**
 - The revised *Code* suggests that **public interest entities** are:
 - listed entities
 - an entity defined by regulation or legislation as a public interest entity

- an entity that is required by **legislation or regulation** to have an audit that is as independent as an audit of a listed entity would be; and
- any other entity that the firm determines to be a public interest entity as it has a large number and wide range of stakeholders.

(c) **Documentation**

Additional guidance is given on what firms are required to **document** to support their conclusions regarding **compliance with independence requirements**.

(d) **Merger or acquisition**

New guidance has been established when a firm unexpectedly becomes related to an audit client as a result of a merger or an acquisition.

A new section has been included on the “**Management responsibilities**” that a firm must not assume in respect of an audit client.

Specific guidance is provided relating to an audit firm providing **internal audit services** to an audit client that is a public interest entity.

Recurring internal audit services must not be provided if they relate to:

- a significant part of the internal controls over the financial reporting
- amounts or disclosures which are material to the financial statements
- financial accounting systems generating significant information to the financial statements

(e) **Partner rotation**

“**Partner rotation**” is now applied to **all key audit partners**, applying to any partner making key decisions and judgments on significant audit matters.

(f) **Joining public interest audit clients**

There is now a mandatory “**cooling off**” period which applies before key audit partners can join public interest audit clients in specific positions.

(g) **Non-audit services**

The provision of **valuation services, recruiting senior management, the provision of corporate services and the provision of IT system services** are being monitored with much stricter guidance. The *Code* now specifically prohibits an audit firm from assuming **management responsibilities** for an audit client.

Firms are not prohibited from providing services to public interest entities where the services relate to material areas to the financial statements. For example, internal control of the IT system or valuation of an asset.

(h) **Tax services**

There are now more guidelines on tax services as, in principle, providing tax services could create a threat to independence when there is heavy tax planning involved in an audit client.

Audit firms should not prepare **material tax calculations** for an audit client which is a public interest entity except in rare situations.

(i) **Fees for public interest entities**

The revised *Code* emphasises that where a firm has an audit client which is a public interest entity and, **for two consecutive years**, the total fees from the client and its related entities represent **more than 15 %** of the total fees, the firm shall:

- discuss that fact with the audit committee; and
- call out engagement quality control reviews by an independent accountant

(j) **Key audit partners**

The *Code* reinforces that key audit partners are not permitted to be evaluated on or compensated for selling non-assurance services to their audit clients.

(k) **Network**

This is defined as a larger structure:

- (a) that is aimed at co-operation; and
- (b) that is clearly aimed at profit or cost sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand-name, or a significant part of professional resources.

SECTION A: General application of the Code

Section A provides **guidance on fundamental ethical principles** where professional accountants are required to apply this conceptual framework to **identify threats** to compliance with the fundamental principles, to **evaluate the significance** of such threats and the **safeguards** to eliminate them or reduce the threats to acceptable levels.

1 Fundamental principles and the conceptual framework approach



Topic highlights

Professional accountants rely on the guidance of an ethical code because they hold positions of trust, and people rely on them. In their business dealings they may encounter situations or be put under pressure to act in ways that further their own advantage, or that of an entity, against the wider public interest or the interest of their profession.

1.1 The importance of ethics

Professional accountants are expected to demonstrate the highest standards of ethical behaviour and to act in the public interest. Around the world accountancy bodies have produced ethical guidance in the form of codes of ethics in order to help professional accountants carry out their responsibilities both to their profession and to the wider public.

In Hong Kong this guidance is given in the *HKICPA's Code of Ethics for Professional Accountants* ("the Code") which states the following about the particular responsibilities of the professional accountant:

'A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a professional accountant's responsibility is not exclusively to satisfy the needs of an individual entity or employer.

The **public interest** is considered to be the collective well-being of the community of people and institutions the professional accountant serves, including entities, lenders, governments, employers, employees, investors, the business and financial community and others who rely on the work of professional accountants.'

Two points are very clear from this: first, the **key reason** that professional accountants must behave ethically is that **a very wide range of people rely on them and their expertise**. The second is that the accountant has a duty to serve not only the entity who has engaged his services or his employer, but the wider public interest – that is, he must be, and must be seen to be, independent.

Professional accountants hold positions of trust by the entities whom they serve, and the users of the information they provide through statutory reporting. They have access to sensitive financial and strategic information which may have a significant impact on the future direction of the business and its stakeholders.

Undertaking these professional obligations may give rise to ethical dilemmas and conflicts of interest; when it does the professional accountant may turn to the guidance laid down by the accountancy bodies, such as the Hong Kong Institute of Certified Public Accountants. As it is impossible to anticipate the very many scenarios which may give rise to these difficulties the guidance is given in the form of fundamental principles, guidance and explanatory notes. The professional accountant is given the freedom to use his own judgment as to how to apply the principles or may seek advice from the HKICPA.

1.2 The fundamental principles

HKICPA Code of Ethics

Integrity. A professional accountant should be **honest** and **straightforward** in all professional and business relationships. Integrity also implies **fair dealing and truthfulness**. Professional accountants should not be associated with information that contains a materially false and misleading statement or the information has been furnished recklessly.

Objectivity. A professional accountant should not be **biased** nor have **conflicts of interest** or **undue influence** to override professional or business judgment. The professional accountant **should not compromise** professional or business judgment due to bias. In addition, they should avoid being exposed to situations that may impair objectivity.

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 when providing professional services.

Professional competence requires both attainment and maintenance of professional competence which requires continuing awareness and understanding of relevant technical professional and business development.

Diligence includes the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

The engagement team should have appropriate training and supervision and if there are any inherent limitations, the professional accountant should notify the entity or users of the financial statements.

Confidentiality. A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any 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.

There is a need to maintain confidentiality of information within the firm or within an employing organisation.

The duty of confidentiality continues even after the end of the relationship between the professional accountant and the entity.

Disclosure of information is allowed only when:

- permitted by **law** and authorised by the entity or employer
- required by **law** in the course of legal proceedings or to appropriate public authorities; and
- there is a **professional duty** or **right** to disclose, ie
 - To comply with technical standards and ethical requirements
 - To protect professional interests of the accountant in legal proceedings
 - To comply with a HKICPA practice review
 - To deal with an inquiry or investigation by HKICPA or other regulatory bodies.

Additional requirements are set out in section 410 “Unlawful Acts or Defaults by Clients of Members” and section 411 “Unlawful Acts or Defaults by or on Behalf of a Member’s Employer”.

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

Professional accountants should not bring the profession into disrepute during its promotion.

Professional accountants should not exaggerate claims for their services that they offer, the qualifications they possess or experience they have gained.

Professional accountants should not make disparaging references or unsubstantiated comparisons to the work of others.

1.3 The conceptual framework

The conceptual framework in the *Code* requires a professional accountant to identify, evaluate and address threats to compliance with the fundamental principles.

A professional accountant has an obligation to evaluate any threats to compliance with the fundamental principles. They should take into account both qualitative and quantitative factors when considering the significance of a threat.

When the threats are identified and the threats are clearly significant, a professional accountant should where appropriate, apply safeguards to eliminate the threats or reduce them to an acceptable level.

A professional accountant should decline or discontinue the service if no safeguards can be implemented.

A professional accountant shall use professional judgment in applying this conceptual framework.

1.4 Threats to compliance with the fundamental principles

There are five general sources of threat:

- (a) **Self-interest threats** – may occur as a result of the **financial** or other interests of a professional accountant or of an immediate or close family member (for example, having a financial interest in an entity)
- (b) **Self-review threats** – may occur when a previous judgment needs to be **reviewed** by the professional accountant responsible for that judgment (for example, auditing financial statements prepared by the firm)
- (c) **Advocacy threats** – may occur when a professional accountant **promotes** a position or opinion that subsequently objectivity may be compromised (for example, promoting shares in a listed entity when that entity is a financial statement audit entity)
- (d) **Familiarity threats** – may occur when due to a close relationship, a professional accountant becomes **too sympathetic** to the interests of others (for example, an engagement team member having family member at the entity)
- (e) **Intimidation threats** – may occur when a professional accountant may be deterred from acting objectively by threats, actual or perceived (for example, threats of replacement due to disagreement).

1.5 Available safeguards

There are three general categories of safeguards:

- Safeguards created by the profession, legislation or regulation
- Safeguards in the work environment
- Safeguards created by the individual

Examples of safeguards created by the **profession, legislation or regulation**:

- (a) Educational training and experience requirements for entry into the profession
- (b) Continuing professional development requirements
- (c) Corporate governance code
- (d) Professional standards
- (e) Professional or regulatory monitoring and disciplinary procedures
- (f) External review by a legally empowered third party of the reports, returns, communication or information produced by a professional accountant

HKICPA issues ethical standards, quality control standards and auditing standards which work together to ensure independence is safeguarded and quality audits are carried out.

Examples of safeguards in the **work environment**:

- (a) Strong firm leadership to emphasise the importance of compliance with the fundamental principles and their expectation that members of the assurance team will act in the public interest
- (b) Establish policies and procedures to implement and monitor quality control of assurance engagement
- (c) Document the firm's independence policies including identification and evaluation of threats
- (d) Document the internal policies and procedures requiring compliance with the fundamental principles
- (e) Establish policies and procedures to identify interests or relationships between the firm or assurance team members, to monitor and manage the undue dependence on fee from a single entity
- (f) Rotate senior audit staff, partners with separate reporting lines of the provision of non-assurance services to an entity
- (g) Establish policies and procedures to prohibit non-team members influence the outcome of the engagement
- (h) Update all partners and professional staff of firm's policies and procedures including giving appropriate training
- (i) Senior management should review the adequate functioning of the safeguarding system
- (j) Advise partners and professional staff to be independent
- (k) Establish disciplinary mechanism to promote compliance with the firm's policies and procedures
- (l) Involve an additional professional accountant to review the work done or otherwise advise as necessary
- (m) Consult an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant
- (n) Use different partners and engagement teams with separate reporting lines for the provision of non-assurance services to entities
- (o) Discuss ethical issues with those in charge of entity governance
- (p) Disclose to those charged with governance the nature of services provided and extent of fees charged
- (q) Involve another firm to perform or reperform part of the engagement

Example of safeguards created by **the individual**:

- (a) Comply with continuing professional development requirements
- (b) Keep records of contentious issues and approach to decision-making
- (c) Maintain a broader perspective on how similar organisations function through establishing business relationships with other professionals
- (d) Use an independent mentor
- (e) Maintain contact with legal advisers and professional bodies

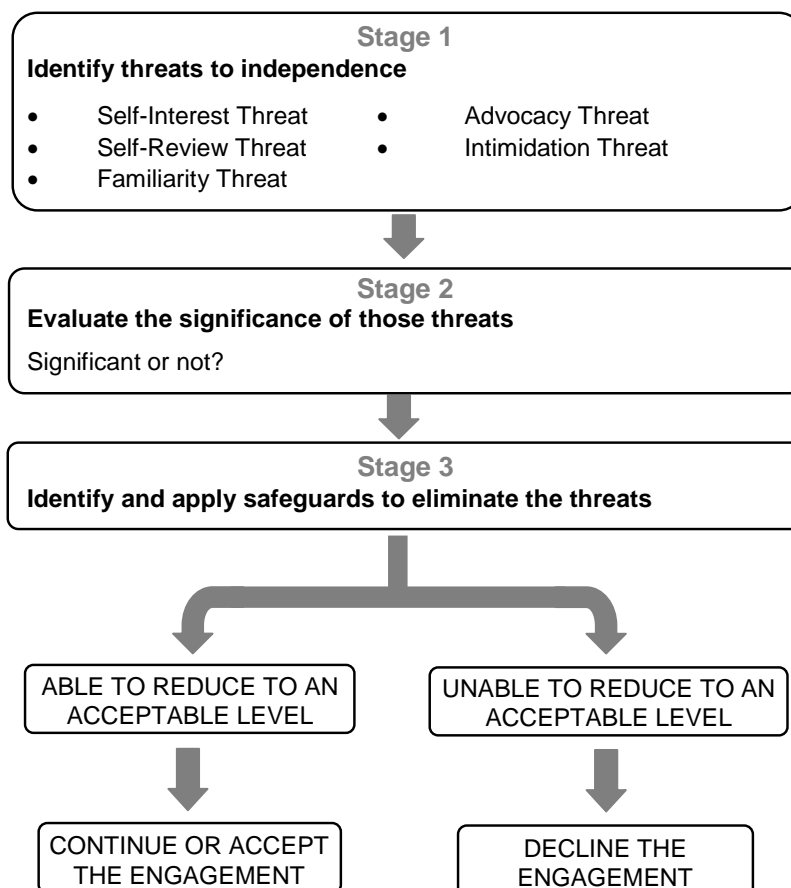
SECTION B: Professional accountants in public practice

Section B provides specific ethical guidance for professional accountants in public practice.

2 Specific guidance: Independence

Professional accountants in public practice should not engage in any activities that impair or might impair integrity, objectivity or the good reputation of the profession.

2.1 Objective of the guidance



The guidance states its purpose in a series of steps. It aims to help firms and members:

Step 1

Identify threats to independence.

Step 2

Evaluate whether the threats are insignificant.

Step 3

If the threats are not insignificant, **identify and apply safeguards** to eliminate risk, or reduce it to an acceptable level.

It also recognises that there may be occasions **where no safeguard is available**. In such a situation, it is only appropriate to:

- **eliminate the interest** or activities causing the threat
- **decline the engagement**, or discontinue it

2.2 What is independence?

A provider of assurance services must be, and be seen to be, independent. What is meant by independence?



Key terms

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

Independence in appearance: 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 or a member of the engagement team's integrity, objectivity or professional scepticism has been compromised.

Firms must evaluate the significance of any threats to independence and then put safeguards in place, where this is possible, to reduce the threat to acceptable levels. If it is not possible to put adequate safeguards in place, it may be better to withdraw services than to risk a conflict of interest. Certain entities, listed companies or those deemed to be of significant public interest due to the wide range of stakeholders involved may be subject to more stringent rules.

Section 290 Independence – Audit and review engagements

This section addresses the independence requirements for **audit engagements and review engagements**, which are assurance engagements in which a professional accountant in public practice expresses a conclusion on financial statements.

Such engagements comprise audit and review engagements to report on a complete set of financial statements and a single financial statement. Independence requirements for assurance engagements that are **not** audit or review engagements are addressed in Section 291.

Degree of independence:

The degree of independence required is less rigid for a low level assurance engagement to non-audit clients than for audit. For example:

	Audit client	Non audit assurance client
Audit	Must be independent *	N/A
Non audit, general use	Must be independent *	Only the assurance team and the firm must be independent.
Non audit, restricted use	Must be independent *	The assurance team and the firm must have no material financial interest in the client.

* Applicable to the assurance team, the firm and the network firm



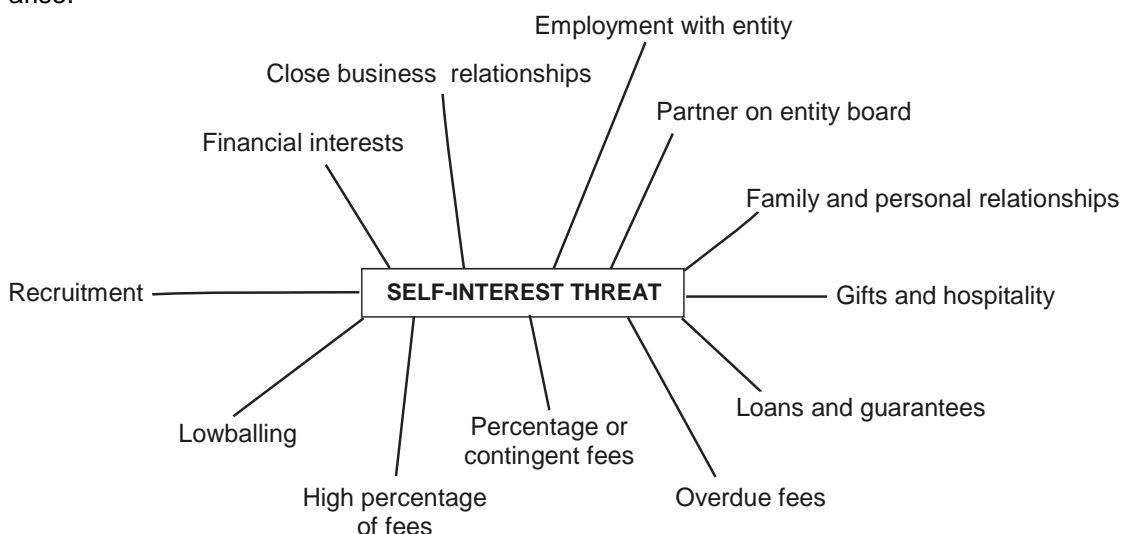
Topic highlights

HKICPA's *Code of Ethics* gives examples of a number of situations where independence might be threatened and suggests safeguards to protect independence.

HKICPA's *Code* gives extensive lists of examples of threats to independence and applicable safeguards. In the rest of this chapter, these threats and some relevant factors and potential safeguards are outlined. Definite rules are shown in bold. You should learn these.

2.3 Self-interest threat

The HKICPA *Code of Ethics* highlights a great number of areas in which a self-interest threat might arise.



2.3.1 Financial interests



Key term

A **financial interest** exists where a firm has a financial interest in an entity's affairs, for example, the firm owns shares in the entity, or is a trustee of a trust that holds shares in the entity.

When considering whether a financial interest in a client constitutes a self interest threat, the significance of the threat should be considered in the light of the following factors:

- Whether the financial interest is direct or indirect
- Role of the owner
- Materiality of the interest

Examples:

- Beneficial interests in shares/other interest
- Overdue fees
- Hold shares in a company's client
- Being trustee of a trusts that holds the shares in the company
- Having a retirement plan that owns shares in the company
- Material indirect ownership of shares

Financial interest in an audit entity may create a self-interest threat.

If a member of the engagement team, a member of that individual's immediate family or a firm has a direct financial interest or a material indirect financial interest in the audit client the self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level.

The parties listed below are not allowed to own a direct financial interest or an indirect material financial interest in a client:

- The assurance firm
- A member of the assurance team
- An immediate family member of a member of the assurance team



Key terms

Direct financial interests are:

- financial interests owned directly by and under the control of an individual or entity
- beneficially owned through a collective investment vehicle such as trust over which the individual or entity has control.

Indirect financial interests are:

- beneficially owned through a collective investment vehicle such as trust over which the individual or entity has no control.

When a close family member has a direct financial interest or a material indirect financial interest in the entity, a self-interest threat is created.

Safeguards available to eliminate the threat or reduce it to an acceptable level are:

- (a) the close family member should dispose of all, or a sufficient amount of the financial interest, at the earliest practical date
- (b) use an additional professional accountant who did not participate in the assurance engagement to review the work done
- (c) remove the member from the engagement team

If a firm or a partner or employee of the firm or a member of that individual's immediate family receive the financial interest by way of inheritance, gift or through a merger, this will cause a self-interest threat.

Safeguards available to eliminate the threat or reduce it to an acceptable level include disposing of the financial interest at the earliest practical date.

Such matters will involve judgment on the part of the partners who are charged with making decisions about ethical issues. For example, what constitutes a material interest? A small percentage stake in a company might be material to its owner. How does the firm judge the closeness of a relationship between staff and their families, in other words, what does immediate mean in this context?

Firms should have quality control procedures requiring staff to disclose relevant financial interests for themselves and close family members. They should also foster a culture of voluntary disclosure on continuous basis so that any potential problems are identified in a timely manner.

2.3.2 Close business relationships

There are various ways of determining whether a firm has an inappropriately close relationship with an entity and methods to address the issue if this is found to be the case. However, there is often a degree of judgment involved.

For example, **purchasing goods and services from an entity on an arm's length basis does not usually constitute a threat to independence.** However, if there are a substantial number of transactions constituting a material interest, there may be a threat to independence and safeguards may be necessary. Whether distribution or marketing arrangements under which the firm acts as distributor or marketer of the entity's products or services or *vice versa* constitute a material interest will also depend on the degree of involvement and the effect of the transactions on both businesses overall.

Where a degree of judgment is involved, **unless the interest is clearly insignificant, an assurance provider should not participate in a venture with an entity.**

Unless any financial interest is immaterial and the business relationship is insignificant to the firm, the threat created would be so significant that no safeguards could reduce the threat to an acceptable level.

Where the significance and nature of the threat to independence involves a single individual member (or a close relation of his), appropriate ethical behaviour would demand that the individual is removed from the engagement team.

2.3.3 Employment with the entity

Independence may be threatened when a professional accountant is employed by both an audit firm and a client entity during the course of his career, or even where there is the prospect of employment at an entity. Where an accountant has been connected with an audit at an entity which subsequently offers employment (or may offer employment):

- Objectivity might be impaired by the motivation to impress a potential future employer
- A finance director who has a background as an audit partner has too much knowledge of the audit firm's systems and procedures to perform independently.

Again, the significance of the threat to independence depends on the specific circumstances. In considering the safeguards that may need to be put in place, consideration would be made of the influence the individual held over the audit in the past, the time interval between the audit and the acceptance of the employment and the capacity for influence the appointment gives over the subject matter of the assurance engagement.

If a former member of the engagement team or a partner of the firm joins an audit client as a director, officer or employee in a position to exert significant influence over the preparation of the client's accounting records of the financial statements and a significant connection remains between the firm and the individual the threat would be so significant that no safeguards would reduce it to an acceptable level. Where no connections remains the significance of the threat would depend on factors including:

- the position taken
- the extent of involvement with the engagement team
- the length of time since the individual was a member of the engagement team
- former position of the individual in the engagement team

Safeguards which may be used include:

- modification of the assurance plan
- reassigning the engagement to another professional accountant with appropriate expertise
- involving an additional independent professional accountant to review the work performed
- carrying out a quality control review of the engagement

A firm should also have quality control procedures requiring an individual involved in **serious employment negotiations with an entity to disclose the fact that these negotiations are taking place to the firm**. The firm may then exercise its discretion and remove the individual from the engagement.

'Cooling off' period

The revised Code requires "cooling off periods" where partners intend to join public interest entities as follows:

- **Key audit partner:** one audit opinion covering a period of not less than 12 months for which the partner was not a member of the engagement team
- **Firm's Managing Partner** (or equivalent): one year

A **new** provision is that an individual who has moved from the firm to a client should not be entitled to **any benefits or payments** from the firm unless pre-determined arrangements have been made.

2.3.4 Partner on entity board

A partner or employee of the firm should not serve on the board of an entity, although in some circumstances it is permissible for a partner or employee of an assurance firm to serve as Company Secretary, or in a similar purely administrative role.

2.3.5 Family and personal relationships

Family or close personal relationships constitute a serious threat to independence. Again, the significance of the threat requires individual circumstances, such as those listed below, to be taken into account:

- (a) The individual's responsibilities on the assurance engagement. This includes the degree of influence the individual may exert over the outcomes of the audit. However, the close family relationships with a directors, officers or employees of an entity should be monitored even if that individual is not part of the particular assurance team).
- (b) The closeness of the relationship, (see the definition given in the *Code* of what constitutes immediate family).
- (c) The role of the other party at the entity. This means whether they exert significant influence over the subject matter of the assurance engagement as a director, company officer or employee and how closely they are involved with the processes and so on being tested).

When an immediate family member of a member of the engagement team is:

- (a) a director or officer of the audit client; or
- (b) an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion

The threats to independence can only be reduced to an acceptable level by removing the individual from the engagement team. The *Code* defines an immediate family member as a spouse or dependant.

When a close family relationship is disclosed it is also usually appropriate to remove the individual from the assurance team.

A firm should have quality control procedures under which employees should disclose if a close family member employed by a client is promoted within the entity so increasing the risk of a significant threat.

If a firm inadvertently violates the rules concerning family and personal relationships there are further safeguards available: in these circumstances it is usual to conduct a quality control review or discuss the matter with the entity's audit committee if it is of sufficient size to have one.

2.3.6 Gifts and hospitality

This is a notoriously difficult area; in some parts of the world, offering gifts or corporate hospitality is an accepted part of business life; in others, it falls into a grey area somewhere between inducement and downright bribery! In general, unless the value of the gift or hospitality is **trivial and inconsequential** a member of an engagement team should decline any offers which may be seen to be intended to influence the judgment of a professional accountant.

2.3.7 Loans and guarantees

The advice on loans and guarantees is similar to that on business transactions. Where the loan or guarantee is not made under normal lending terms safeguards are unlikely to reduce the self-interest threat to an acceptable level.

If the loan from a financial institution, is made on an arm's length usual commercial basis, then there is no threat to independence. For individuals, a loan of this sort is likely to be material, such as a mortgage, but as long as usual commercial terms apply, there is no impairment to independence. If a loan to a firm is deemed material it is necessary to apply safeguards to reduce the risk to an

acceptable level. One safeguard likely to be used is an independent review (by a partner from another office in the firm).

However, the firm or an individual on the assurance engagement should never enter into any loan or guarantee arrangement with an entity that is not a bank or similar institution.

The advice on loans and guarantees falls into two categories:

- client is a bank or similar institution
- other situations

2.3.8 Overdue fees

By allowing fees to remain overdue, the professional accountant runs the risk of effectively offering a loan to an entity. The professional accountant may then run the risk of being in breach of the rules set out above.

Appropriate safeguards include an independent review to ensure that the fees charged are fair for the work performed. Policies should be in place to ensure that unpaid fees do not build up to unfeasibly high levels. Unpaid fees should be discussed with the entity's senior management promptly. If the fees remain unpaid then the firm should consider resignation.

2.3.9 Percentage or contingent fees



Key term

Contingent fees are fees which are calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm.

A firm should not enter into a contingent fee arrangement for any assurance engagement as payment arrangements based on outcomes create self-interest and advocacy threats which cannot be reduced to acceptable levels through the application of suitable safeguards.

Contingent fees charged on non-assurance engagement

A contingent fee **charged directly or indirectly by a firm** in respect of a non-assurance service provided to an audit client may also create a **self-interest threat**. The threat created would be so significant that **no safeguards** could reduce the threat to an acceptable level if:

- the fee is charged by the **firm expressing the opinion** on the financial statements and the fee is material or expected to be material to that firm;
- the fee is **charged by a network firm** that participates in a significant part of the audit and the fee is material or expected to be material to that firm; or
- the outcome of the non-assurance service, and therefore the amount of the fee, is dependent on a future or contemporary judgment related to the audit of a material amount in the financial statements.

All arrangements shall be prohibited.

Compensation and evaluation policies

A **self-interest threat** is created when a member of the engagement team is evaluated on or compensated for selling non-assurance services to that audit client.

The significance of the threat shall be evaluated and, if the threat is not at an acceptable level, the firm shall either revise the compensation plan or evaluation process for that individual or apply safeguards to eliminate the threat or reduce it to an acceptable level.

A **key audit partner** shall not be evaluated on or compensated based on that partner's success in selling non-assurance services to the partner's audit client. This is not intended to prohibit normal profit-sharing arrangements between partners of a firm.

2.3.10 Undue dependence on total fees

A self-interest threat arises where the total fees generated by an entity represent a large proportion of a firm's total revenue.

Whether it is a situation of undue dependence may be mitigated by factors such as the size and structure of the firm and how long it has been trading (a new firm may not have a wide enough client base to follow the ruling emboldened above).

Similar threats may be created by situations where the fees generated by an entity represent a large proportion of the revenue brought in by an individual partner.

Safeguards in these situations include:

- discussion of the matter with the entity's senior management or the audit committee if it has one
- taking steps to reduce the financial dependency on the entity
- obtaining external or internal quality control reviews
- consulting a third party such as HKICPA

Audit Clients that are Public Interest Entities (new provision)

Where an audit client is a **public interest entity** and, for **two consecutive years**, the total fees from the client and its related entities represent **more than 15% of the total fees** received by the firm expressing the opinion on the financial statements of the client, the firm shall disclose to those charged with governance of the audit client the fact that the total of such fees represents more than **15 percent of the total fees** received by the firm, and discuss which of the safeguards below it will apply to reduce the threat to an acceptable level, and apply the selected safeguard:

- **A pre-issuance review** – Prior to the issuance of the audit opinion on the second year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, **performs an engagement quality control review** of that engagement or a professional regulatory body performs a review of that engagement that is equivalent to an engagement quality control review.
- **A post-issuance review** – After the audit opinion on the second year's financial statements has been issued, and before the issuance of the audit opinion on the third year's financial statements, a professional accountant, who is not a member of the firm expressing the opinion on the financial statements, or a professional regulatory body performs a review of the second year's audit that is equivalent to an engagement quality control review.

2.3.11 Lowballing

Lowballing is the term used to describe the situation where a firm quotes a significantly lower fee level for an assurance service than would have been charged by the predecessor firm usually in order to gain other more lucrative business. A self-interest threat arises which must be safeguarded against. If the firm wins the tender the following safeguards should be applied:

- Careful record keeping to demonstrate that the firm used appropriate staff, spent sufficient time, and adhered to appropriate technical and professional standards in carrying out the engagement;
- Demonstration that the assurance engagement complied with all applicable assurance standards, guidelines and quality control procedures

In other words, the low generation of fee revenue must not have any adverse impact on the quality of the review carried out. Lowballing and the significant low fee issue below carry the risks of fee disputes, if the company is eventually forced to make a choice between losing money or compromising on quality or if the lucrative other business the firm hoped to win on the back of the loss-making audit does not materialise.

2.3.12 Significant low fee

A firm is entitled to charge a significant low fee for any reason but should be aware of the threat to objectivity this creates. This fee strategy may cause a self-interest threat and call into question the

professional competence and due care owed by the firm. Both independence and quality of work may be compromised as it may be difficult to perform the engagement in accordance with applicable technical and professional standards for the fee charged.

The professional accountant should consider if there is:

- any terms on securing the contract to supply other non-audit services (lowballing issue)
- any compromise on the quality of the audit work
- any restriction on senior staff working on the audit
- any possibility the entity was misled as to the basis on which fees for the current and subsequent years were to be determined
- awareness by the entity of all the terms of the engagement and fees charged
- appropriate review to ensure work is done fully in accordance with auditing standards; and should
- appropriate time and competent staff assigned to the engagement.

By engaging in these risky pricing strategies the firm not only threatens its independence but also raises the risk of fee disputes and negligence claims that could do long-term damage to the business.

2.3.13 Recruitment

Professional accountants may offer HR consultancy services (see the further discussion of this in 2.4 below). However, recruitment and assurance services offered by the same firm may result in a conflict of interest and either the assurance business or the consultancy business should be declined. It may be acceptable for the assurance firm to play a limited part in say, the recruitment of a senior officer at an entity who uses their assurance services, if the final decision for the appointment rests with another party.

2.3.14 Receiving or paying referral and commission

Paying a commission or referral fee or accepting this kind of fee is acceptable. However, accepting a referral fee may create **self-interest threat** to objectivity and call into question professional competence and due care. Safeguards should be applied:

- (a) Disclose to the entity the arrangement to pay/receive a referral fee to another professional accountant for the work passed onto them
- (b) Obtain advance agreement from the entity for commission arrangements in connection with the sale by a third party of goods or services to the entity



Self-test question 1

Kwok & Co have been the auditors of Kowloon Bank for a number of years.

- (a) Kowloon Bank operates a staff scheme offering all members of staff low rate mortgage deals. The staff rate is currently set at 3.5% below the bank prime rate. The Head of Lending of Kowloon Bank tells the audit engagement partner at Kwok & Co, with whom he has dealt for a number of years, that Kowloon Bank would like to extend the staff scheme in respect of low rate mortgages to all members of staff at Kwok & Co, as a token of their appreciation of Kwok & Co's services.
- (b) An audit assistant, who was on the audit of Kowloon Bank last year is considering resignation from Kwok & Co to accept a trainee manager position at Kowloon Bank.

The audit engagement partner for Kowloon Bank has just become aware of this situation.

Required

Explain any professional and ethical issues in each of the above situations.

(11 marks)

HKICPA February 2006

(The answer is at the end of the chapter)

2.4 Self-review threat



Self-review threats arise when a professional accountant, or a firm of professional accountants, have previously been involved in performing a service which they are then called upon to review. This may include setting up financial systems they are then asked to review, or preparing financial records or valuations for the financial statements they are then asked to audit. The risk is greater when the service was performed very recently. As market competition has encouraged firms of professional accountants to expand the range of services they may offer entities, so the risk of self-review has increased. The table below shows a range of the services that may be provided and there follows a discussion about how the provision of these services may impair independence.

Services provided by professional accountants

Bookkeeping

Preparation of financial statements

Tax services, although generally these are not seen to impair independence

Design and implementation of financial information systems

Appraisal, valuation services and fairness opinions

Actuarial services

Internal audit services

Management functions, but there are strict rules about the degree to which assurance advisers may intervene in the management decisions of the entity

Human resources – such as recruitment and selection of senior management, provision of temporary staff cover and so on

Corporate finance, broker-dealer services, accessing finance and so on

Legal services and litigation support

Risk of self-review

The HKICPA *Code* gives rules about the other services firms may provide to their entities, (see sections 2.4.2–2.4.9 below).

The distinction between listed companies, (or public interest companies), and private companies is an important one in the provision of other services to entities. The rules are much more stringent for listed companies and those deemed to be of public interest.



Key terms

Listed companies are those whose shares have been admitted to a recognised exchange, such as the Stock Exchange of Hong Kong.

Public interest companies are those which for some reason (size, nature, product) are in the “public eye”. Professional accountants should treat these as if they are listed companies.

2.4.1 Recent service

The *Code* sets out the following rule with regard to individuals who have completed a recent period of service with an entity:

Individuals who have held the role of director or served as an officer of the entity, or been an employee in a position to exert direct, significant influence over the subject matter of the assurance engagement in the period under review or the previous two years should not be assigned to the assurance team.

If an individual had been closely involved with the entity but outside of the time limits established above, the assurance firm should consider the threat to independence and apply safeguards, if appropriate.

This may be to:

- obtain a quality control review of the individual’s work on the assignment
- discuss the issue with the audit committee if the entity has one

2.4.2 General other services

Another rule which should be learned is that, where the assurance firm is providing other services for an entity:

Professional accountants are not allowed to:

- **authorise, execute or consummate a transaction**
- **sanction a particular course of action for the entity to pursue (this is a matter for its own management)**
- **report in a management capacity to those charged with governance**

However, keeping custody of an entity’s assets, supervising the entity’s employees in the performance of their normal duties, and preparing source documents on an entity’s behalf are a common requirement for assurance firms which could also pose significant self-review threat, Safeguards which may be used to address this are described below:

- (a) Segregation of duties: the assurance firm can make sure that different staff are used on the assurance team to the staff engaged in the other capacity
- (b) Seeking the advice of an independent professional accountant
- (c) Clear quality control policies establishing what staff are and are not allowed to do on behalf of entities
- (d) Making appropriate disclosures and discussion of the matter with those charged with governance

- (e) Resigning from the assurance engagement
- (f) Establishing policies and procedures to prohibit professional accountants from making managerial decisions on behalf of the entity

2.4.3 Preparing accounting records and financial statements

Management is responsible for the **preparation and fair presentation** of the financial statements in accordance with the applicable financial reporting framework.

Professional accountants routinely assist management with the preparation of financial statements and give advice about accounting treatments and journal entries. A self-review threat arises if the same firm is then asked to audit the accounting records that they have prepared.

If the firm is listed or public interest, it **should not prepare accounts or financial statements for a listed or public interest entity**, unless an emergency arises.

The rules are more relaxed for small entities where a single firm is likely to be involved with the business in a number of capacities. In these situations, firms must analyse the risks arising and put safeguards in place to reduce the risk to an acceptable level. Safeguards include:

- using staff members other than assurance team members to carry out work
- obtaining entity approval for work and underlying assumptions undertaken

Audit clients that are not public interest entities

The firm may provide services related to the preparation of accounting records and financial statements to an audit client that is **not a public interest entity** where the services are of a routine or mechanical nature, so long as any self-review threat created is reduced to an acceptable level.

For any client, assurance firms are also **not allowed** to:

- determine or change journal entries without client approval
- authorise or approve transactions
- prepare source documents

Audit clients that are public interest entities

Except in **emergency situations**, a firm shall not provide to an audit client that is a public interest entity accounting and bookkeeping services, including payroll services, or prepare financial statements on which the firm will express an opinion or financial information which forms the basis of the financial statements.

‘Emergency situations’

Accounting and bookkeeping services may be provided to audit clients in emergency or other unusual situations when it is impractical for the audit client to make other arrangements:

- **Only if the firm has the resources and necessary knowledge** of the client’s systems and procedures to assist the client in the timely preparation of its accounting records and financial statements
- Restriction on the firm’s ability to provide the services would result in significant difficulties for the client to comply with regulatory requirements

The following conditions must be met if professional accountants are to perform accounting and bookkeeping services:

- Those who provide the services are not members of the engagement team;
- The services are provided for only a short period of time and are not expected to recur; and
- The situation is discussed with those charged with governance.

However, for any entity, firms are never allowed to:

- (a) determine or change journal entries without entity’s approval
- (b) authorise or approve transactions

- (c) prepare original source documents
- (d) report on behalf of management to those charged with governance
- (e) supervise an entity's employee in performing normal activities

2.4.4 Temporary staff assignments

The lending of staff by a firm to an audit client may create a **self-review threat**. Such assistance may be given, but only for a short period of time and the firm's personnel shall not be involved in:

- providing non-assurance services that would not be permitted under the Code; or
- assuming management responsibilities.

In all situations, the audit client shall be **responsible for directing and supervising** the activities of the loaned staff.

2.4.5 Valuation services



Key term

A **valuation** comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.

If a firm performs a valuation to be included in the entity's financial statements which are then subsequently audited by the firm, a self-review threat arises.

A firm should not carry out valuations on matters:

- (a) **which are material to the financial statements** and
- (b) if the valuation is subject to high degree of subjectivity.

No safeguard is available to reduce the threat to an acceptable level under these circumstances.

If the valuation is neither material nor subject to high degree of subjectivity, the firm may apply safeguards to ensure that the risk is reduced to an acceptable level. The following matters need to be considered:

- The extent of the entity's knowledge of the relevant matters in making the valuation
- The degree of judgment involved
- How much use is made of established methodologies
- The degree of uncertainty in the valuation

The firm may use the following safeguards to manage the risk:

- Second partner review
- Confirming that the entity understands how the valuation is reached and the underlying assumptions
- Ensuring the entity acknowledges its responsibility for the valuation
- Using separate staff for the valuation and the audit

For audit clients that are public interest entities

A firm shall not provide valuation services to an audit client that is a public interest entity if the valuations would have a material effect, separately or in the aggregate, on the financial statements on which the firm will express an opinion.



Self-test question 2

You are the audit manager of a CPA firm, Yu & Yu. You are responsible for the audit of the financial statements of a manufacturing and trading group, La'Monsa Limited ("La'Monsa"), for the year ended 31 December 20X6. The group's principal product is clothing. In the last financial year, La'Monsa set up a subsidiary to manufacture footwear products. They acquired a brand and set up a production line.

When planning the audit work for the year ended 31 December 20X6, you learnt that the footwear business had not been successful and production had been suspended.

In a meeting with Mr. Jun, the Chief Executive Officer ("CEO") of La'Monsa, you raised your concerns regarding valuation of the brand and production facilities in the footwear business. The CEO believed that the brand was acquired last year and was still quite popular, and the machinery and equipment were still workable. He also advised you that a merger of La'Monsa with another footwear company was under negotiation. As valuation services were provided by your firm, he suggested your firm, Yu & Yu, prepare a valuation report on the brand and the machinery and equipment. Mr. Jun also suggested your firm use the valuation report in the audit of the financial statements for the year ended 31 December 20X6.

Required:

- Discuss the general independence consideration for Yu & Yu in accepting non-assurance engagements by its existing audit client. **(5 marks)**
- Discuss the independence consideration in the specific circumstances of La'Monsa's suggestion that Yu & Yu be appointed to provide valuation services. **(10 marks)**

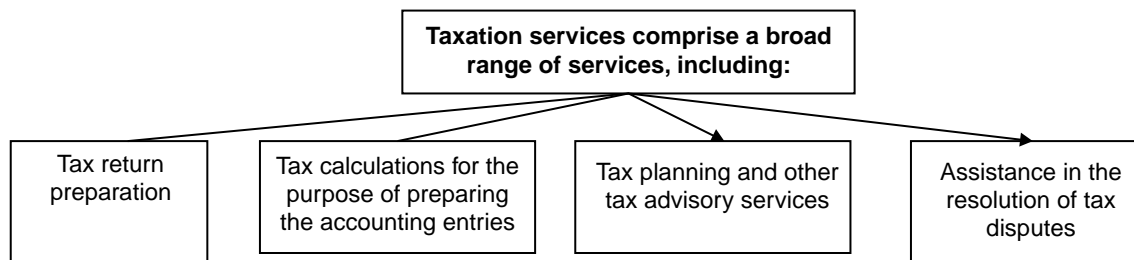
(Total = 15 marks)

HKICPA May 2007

(The answer is at the end of the chapter)

2.4.6 Taxation services

Generally, the provision of taxation services is not seen as any threat to independence.



Performing certain tax services creates **self-review and advocacy threats**.

The existence and significance of any threats will depend on:

- the system by which the tax authorities assess and administer the tax in question and the role of the firm in that process
- the complexity of the relevant tax regime and the degree of judgment necessary for application
- the particular characteristics of the engagement
- the level of tax expertise of the client's employees.

Tax return preparation

Accordingly, providing such services **does not** generally create a threat to independence if management takes responsibility for the returns including any significant judgments made.

Tax calculations for the purpose of preparing accounting entries

(i) **Audit clients that are not public interest entities**

Preparing calculations of current and deferred tax liabilities (or assets) for an audit client for the purpose of preparing accounting entries that will be subsequently audited by the firm creates a self-review threat.

Safeguards shall be applied when necessary to eliminate the threat or reduce it to an acceptable level.

(ii) **Audit clients that are public interest entities**

Except in emergency situations, in the case of an audit client that is a public interest entity, a firm shall not prepare tax calculations of current and deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the financial statements on which the firm will express an opinion.

Tax planning and other tax advisory services

Such services involve advising the client how to structure its affairs in a tax efficient manner or advising on the application of a new tax law or regulation.

A self-review threat may be created where the advice will affect matters to be reflected in the financial statements.

The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

Safeguards:

- Using professionals who are not members of the engagement team to perform the service
- Having a tax professional, who was not involved in providing the tax service, advise the engagement team on the service and review the financial statement treatment
- Obtaining advice on the service from an external tax professional; or
- Obtaining pre-clearance or advice from the tax authorities.

Where the **effectiveness of the tax advice** depends on a particular accounting treatment or presentation in the financial statements and the self-review threat would be so significant that **no safeguards** could reduce the threat to an acceptable level. Accordingly, a firm shall not provide such tax advice to an audit client.

Assistance in the resolution of tax disputes

An advocacy or self-review threat may be created when the firm represents an audit client in the resolution of a tax dispute once the tax authorities have notified the client that they have rejected the client's arguments on a particular issue and either the tax authority or the client is referring the matter for determination in a formal proceeding,

Where the taxation services involve acting as an advocate for an audit client before a public tribunal or court in the resolution of a tax matter and the amounts involved are material to the financial statements on which the firm will express an opinion, the advocacy threat created would be so significant that no safeguards could eliminate or reduce the threat to an acceptable level.

2.4.7 Internal audit services

Internal audit activities may include:

- monitoring of internal controls
- examination of financial and operating information
- review of the economy, efficiency and effectiveness of operating activities
- review of compliance with laws, regulations and other external requirements, and with management policies and directives

The **provision of internal audit services** to an audit client creates a self-review threat to independence if the firm uses the internal audit work in the course of a subsequent external audit.

Performing a significant part of the client's internal audit activities increases the possibility that firm personnel providing internal audit services will assume a management responsibility.

A firm may provide internal audit services to an entity, without impairment to independence so long as the firm ensures that the entity recognises its responsibility for establishing, maintaining and monitoring the internal controls. Usually the following safeguards are put in place:

- (a) An employee of the entity is made responsible for all internal audit activities
- (b) The entity approves all of the work undertaken by the internal engagement team

Audit clients that are public interest entities

In the case of an audit client that is a public interest entity, a firm **shall not provide internal audit services** that relate to:

- a significant part of the internal controls over financial reporting
- financial accounting systems that generate information that is, separately or in the aggregate, significant to the client's accounting records or financial statements on which the firm will express an opinion; or
- amounts or disclosures that are, separately or in the aggregate, material to the financial statements on which the firm will express an opinion.

2.4.8 Corporate finance

Certain aspects of corporate finance create self-review threats that cannot be reduced to an acceptable level by safeguards. A **firm is not allowed to promote, deal in or underwrite an entity's shares under any circumstances**. Similarly, **it is also not allowed for a firm to commit an entity to the terms of a transaction or consummate a transaction**. There are other corporate finance services, formulating corporate strategies, raising capital or providing restructuring advice which may be acceptable without impairment to independence, providing that appropriate safeguards are in place. Such safeguards include using different teams of staff, and making sure policies are in place to ensure that no management decisions are taken on behalf of the entity and these are closely controlled.

The Hong Kong Takeovers and Share Repurchase Codes

A member who provides takeover services for clients is required to comply with the Codes which are expressly applied to professional advisers as well as to those engaged in the securities market.

The Stock Exchange of Hong Kong Limited's (Stock Exchange) Rules Governing the Listing of Securities (Listing Rules)

Members' attention is also drawn to the Listing Rules in particular when acting as a sponsor or as an independent financial adviser.

2.4.9 Other services

There are other services a firm might offer to entities.

IT services

Providing systems services may create a **self-review threat** depending on the nature of the services and the IT systems.

Providing services to an audit client that is **not a public interest entity** involving the design or implementation of IT systems that:

- (a) form a significant part of the internal control over financial reporting, or
- (b) generate information that is significant to the client's accounting records or financial statements on which the firm will express an opinion creates a self-review threat.

In the case of an audit client that is a **public interest entity**, a firm shall not provide services involving the design or implementation of IT systems that:

- (a) form a significant part of the internal control over financial reporting, or
- (b) generate information that is significant to the client's accounting records or financial statements on which the firm will express an opinion.

Temporary staff cover

Providing recruiting services to an audit client may create **self-interest, familiarity or intimidation threats**.

The firm may generally provide such services as reviewing the professional qualifications of a number of applicants and providing advice on their suitability for the post.

A firm **shall not** provide recruiting services to an audit client that is a public interest entity with respect to a director or officer of the entity or senior management in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm relies.

Litigation support services

Providing legal services to an entity that is an audit client may create both self-review and advocacy threats.

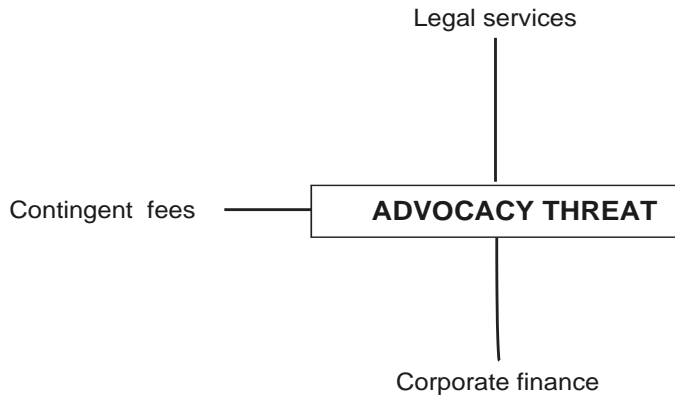
Acting in an advocacy role for an audit client in resolving a dispute or litigation when the amounts involved are material to the financial statements on which the firm will express an opinion would create advocacy and self-review threats so significant that no safeguards could reduce the threat to an acceptable level.

The appointment of a partner or an employee of the firm as General Counsel for legal affairs of an audit client would create self-review and advocacy threats that are so significant that no safeguards could reduce the threats to an acceptable level.

Legal services

In each case, the firm should consider whether there are any barriers to independence and whether these can be reduced by appropriate safeguards. Among the scenarios which might fall into this category are where a firm is asked to design internal control IT systems, which it would later review as part of its audit, or a professional accountant from the firm was seconded to cover the finance director's maternity leave. Before you read on, what would you consider to be appropriate ethical behaviour in those two circumstances?

2.5 Advocacy threat

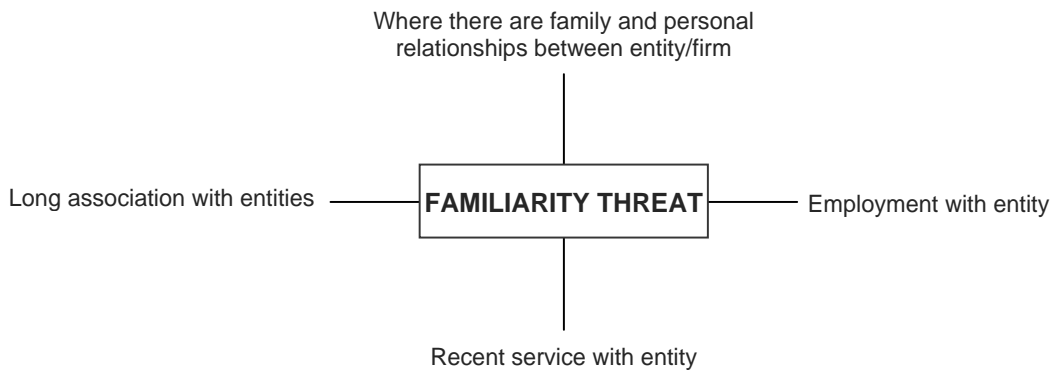


An advocacy threat often arises in the provision of legal or corporate finance services. To avoid this threat firms must avoid being in the position of taking the entity's part in a dispute or somehow acting as their advocate in a way that threatens the appearance of independence. Examples are when a firm has provided legal services to an entity and, perhaps defended them in a legal case. Corporate finance examples are where the firm gives such as advice on debt reconstruction and negotiates with the bank on the entity's behalf or deals or acts as a promoter of shares for an entity. In these instances a professional accountant may **promote or may be seen to promote** an entity's position to the point that objectivity may be impaired.

Again, the firm may be able to reduce the threat by using appropriate safeguards, including separate teams and disclosures, but if the threat cannot be reduced to an acceptable level the firm must withdraw from the engagement.

2.6 Familiarity threat

A familiarity threat often arises in conjunction with a self-interest threat. Independence is jeopardised by the firm and its staff becoming too closely connected or too familiar with or sympathetic to the entity and its employees. Professional scepticism may be severely impaired in circumstances.



2.6.1 Long association of senior personnel with entities

A long association with an entity may erode the independence of senior members of staff as the length of service may mean they become too close to or too overly sympathetic to the business to remain objective and exercise professional scepticism. Firms should continually monitor the relationship between staff and established entities, including requirements to disclose any promotions or changes within the entities which may introduce a new risk. Control can be established by the use of safeguards such as rotation of senior personnel, second partner reviews, and internal independent quality control reviews.

In addition, the *Code of Ethics* goes further for listed and public interest entities with a list of specific rules to prevent this situation from arising. It is in your interest to learn them!

The rules state that **for the audit of listed or other public interest entities:**

- The engagement partner should **be rotated after a pre-defined period**
- Other key audit partners should be rotated after a pre-defined period, **normally no more than seven years, and should not return to the engagement until a period of two years has elapsed**
- **The individual responsible for the engagement quality control review should be rotated after a pre-defined period**

If an entity becomes a listed entity, the engagement partner, other key partners and quality control personnel should only continue in those positions for another two years. Judgment may need to be exercised for more junior staff based on the length of time they have been involved with the audit.

Flexibility is required for smaller firms where the size constraint may mean rotation is impracticable or reliance on a key person's expertise would mean the risk to technical quality is greater than that derived from the previous connection. In this case, the firm must devise suitable safeguards to make sure independence is preserved.

(a) **Listed companies and other public interest entities:**

The rules state that **for the audit of listed or other public interest entities:**

- The engagement partner should **be rotated after a pre-defined period**
- Other key audit partners should be rotated after a pre-defined period, **normally no more than seven years, and should not return to the engagement until a period of two years (or five years if returning as engagement partner) has elapsed**
- The individual responsible for the engagement quality control review should be rotated after a pre-defined period, **normally no more than seven years, and should not return to the engagement until a period of two years has elapsed.**

If an entity becomes a listed entity, the engagement partner, other key partners and quality control personnel should only continue in those positions for **another two years**. Judgment may need to be exercised for more junior staff based on the length of time they have been involved with the audit.

(b) **Rotation of key audit partners**

Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time.

Despite the above, key audit partners whose continuity is especially important to audit quality may, in rare cases due to unforeseen circumstances outside the firm's control, be permitted **an additional year** on the engagement team as long as the threat to independence can be eliminated or reduced to an acceptable level by applying safeguards.

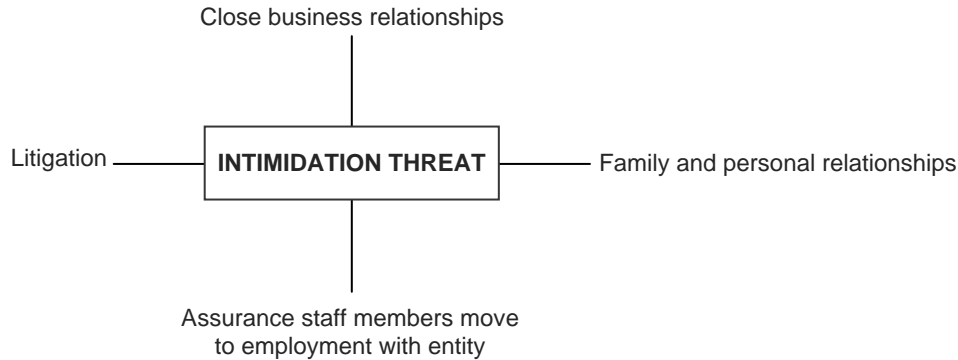
When an audit client becomes a public interest entity, the length of time the individual has served the audit client as a key audit partner before the client becomes a public interest entity shall be taken into account in determining the timing of the rotation.

If the individual **has served the audit client as a key audit partner for five years or less** when the client becomes a public interest entity, the number of years the individual may continue to serve the client in that capacity before rotating off the engagement is seven years less the number of years already served.

When a firm has **only a few people** with the necessary knowledge and experience to serve as a key audit partner on the audit of a public interest entity, rotation of key audit partners may not be an available safeguard.

2.7 Intimidation threat

An intimidation threat arises when members of the assurance team are intimidated or pressured to act unethically by entity staff. This generally means the firm has something to lose or is under pressure in some way which the entity is trying to push to its own advantage. Loss of business, replacement with another auditor and litigation are some of the methods by which an entity may try to intimidate a firm.



A professional accountant may be dissuaded from using objectivity and exercising professional scepticism by threats, whether actual or perceived from directors of an entity.

There are three main types of threat:

- Loss of business:** for instance, as a result of a disagreement over the application of an accounting principle, the entity may threaten to change its auditors if they wish to modify their report as a result of the dispute.
- Loss of fee revenue:** for instance, the entity may apply pressure to reduce the extent of work performed by the professional accountants unjustifiably in order to reduce the fees.
- Litigation:** defending a claim for negligence can be time consuming, publicly damaging and expensive, even if the assurance firm were to eventually win the case (see below).

2.7.1 Actual and threatened litigation

Litigation, threatened or real, is a very serious threat indeed for firms: not only does it involve the loss of the immediate client, the firm may suffer further losses from the associated negative publicity and association with negligent behaviour, even if successfully defended. The threat may lead to the firm being put under pressure to publish an unqualified audit report although they have been qualified in the past, for example. The risk is so great that if the litigation is at all serious, the firm should consider resignation.

However, good control systems should be in place to prevent such situations arising. When they do, the following considerations should be taken into account:

- The materiality of the litigation
- The nature of the assurance engagement
- Whether the litigation relates to a prior assurance engagement

The following safeguards could be applied:

- Disclosing to the audit committee the nature and extent of the litigation
- Removing specific affected individuals from the engagement team
- Involving an additional professional accountant on the team to review work

2.7.2 Second opinions

An entity may seek a **second opinion** from a different firm when they are unhappy with the audit opinion given or the work performed. The second firm, as it is not officially appointed, is notable to give a formal audit opinion on the financial statements. However, if a another firm indicates to an entity's management that a different audit opinion might be acceptable, the appointed firm may feel

under pressure to change the audit opinion in order to preserve the client relationship. In effect, a self-interest threat arises.

In practice, second opinions often cause independence issues for firms of professional accountants and care should be taken if asked to provide one.

A company director is free to talk to a another firm about the treatment of matters in the financial statements if he believes there is a good reason for doing so. However, new accounting standards are increasingly prescribing a single method of treatment reducing the scope for subjectivity and the need for this kind of second opinion. Where an opinion like this is sought, the second firm is relying on the director to communicate all of the relevant information on which the original opinion has been based in a factual manner ie without any bias which may lead the professional accountants to take a view that the entity might prefer. It is usual for the second firm to request the co-operation of the appointed firm in order to ensure they have all the information they need. If this is refused, there are probably good reasons why the engagement should be declined.

Safeguards are:

- obtain the entity's consent
- describe the limitations surrounding any opinion in communications with the entity
- provide the existing professional accountant with a copy of the opinion

2.8 Other assurance engagements

Section 291 Independence – Other assurance engagements

This section addresses independence requirements for assurance engagements that are not audit or review engagements. The basic principles are the same as those set out in section 290. However, the following additional points should be noted.

2.8.1 Employment with an audit client

The basic principles are the same as those set out in section 290 although section 291 does not include specific “cooling off” provisions.

2.8.2 Contingent fees

The basic principle is the same as that described in section 290, ie a contingent fee should not be charged in respect of an assurance engagement. In addition, a contingent fee should not be charged in respect of a non-assurance service provided to an assurance client if the outcome of the non-assurance service (and therefore the amount of the fee) is dependent on a judgment related to the subject matter of the assurance engagement. For other contingent fee arrangements charged by a firm for a non-assurance service to an assurance client the significance of any threat will have to be evaluated and safeguards applied.

2.8.3 Multiple responsible parties

In some assurance engagements, whether **assertion-based or direct reporting**, there might be several responsible parties. In determining whether it is necessary to apply the provisions in this section to each responsible party in such engagements, the firm may take into account whether an interest or relationship between the firm, or a member of the assurance team, and a particular responsible party would create a threat to independence that is not trivial and inconsequential in the context of the subject matter information.

2.8.4 Interpretation 2005-01 (Revised June 2010 to conform to changes resulting from the IESBA's project to improve the clarity of the Code)

This Interpretation focuses on the application issues that are particular to assurance engagements that are not financial statement audit engagements.

Assertion-Based Assurance Engagements

In an **assertion-based assurance engagement** independence is required from the responsible party, which is responsible for the subject matter information and may be responsible for the subject matter.

Direct reporting assurance engagements

In a **direct reporting assurance engagement**, the professional accountant in public practice either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users.

2.9 HKSQC 1: Quality control: Independence

HKSQC 1 (Clarified) is the quality control standard issued by HKICPA and within it, there is a particular requirement which refers to ethics.

Firm should establish policies and procedures to emphasise the compliance on principles of professional ethics which should be enforced by:

- (a) leadership of the firm
- (b) training
- (c) monitoring
- (d) process of dealing with non-compliance

HKSQC 1.21-23

The standard sets out some detailed requirements with regard to independence.

The firm shall establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including network firm personnel), maintain independence where required by the Code. Such policies and procedures shall enable the firm to:

- (a) communicate its independence requirements to its personnel and, where applicable, others subject to them, and
- (b) identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.

Such policies and procedures shall require:

- (a) engagement partners to provide the firm with relevant information about client engagements, including the scope of services, to enable the firm to evaluate the overall impact, if any, on independence requirements
- (b) personnel to promptly notify the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken, and
- (c) the accumulation and communication of relevant information to appropriate personnel so that:
 - (i) the firm and its personnel can readily determine whether they satisfy independence requirements
 - (ii) the firm can maintain and update its records relating to independence, and
 - (iii) the firm can take appropriate action regarding identified threats to independence that are not at an acceptable level.

The firm shall establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations.

The policies and procedures shall include requirements for:

- (a) Personnel to promptly notify the firm of independence breaches of which they become aware
- (b) The firm to promptly communicate identified breaches of these policies and procedures to:
 - (i) the engagement partner who, with the firm, needs to address the breach, and
 - (ii) other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action, and
- (c) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph 23 (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

At least annually, the firm shall obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the HKICPA Code and national ethical requirements.

2.9.1 Familiarity threat

HKSQC 1.24

Last, HKSQC 1 (Clarified) sets out some specific guidance in relation to the threat of over-familiarity with entities.

The firm shall establish policies and procedures:

- (a) setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time, and
- (b) requiring for audits of financial statements of listed entities, the rotation of the engagement partner and the individuals responsible for engagement quality control review, and, where applicable, others subject to rotation requirements after a specified period in compliance with relevant ethical requirements.

3 Specific guidance: Confidentiality



Topic highlights

HKICPA recognises a duty of confidentiality and several exceptions to it.

3.1 Duty of confidence

A professional accountant has a duty of confidentiality to his client. This principle is encapsulated in the HKICPA *Code of Ethics* which states that a professional accountant who acquires sensitive information in the course of his work, should not use, nor appear to use, that information to his own advantage or to the advantage of any third party with which he is connected.

It is an implied term of any agreement of engagement that the professional accountant will not discuss the entity's affairs to any third party without the entity's consent. There are a few recognised exceptions to this rule of confidentiality discussed below.

3.2 Recognised exceptions to the rule of confidentiality

Obligatory disclosure. If a member knows or suspects the entity to have committed an offence of treason he is obliged to disclose all the information at his disposal to a competent authority. Local legislation may also require the firm to disclose other infringements.

A professional accountant must disclose information if compelled to do so by a court order (process of law).

If a member is requested to assist the police, the tax authorities or any other authority by providing information about an entity's affairs in connection with inquiries being made he should first inquire under what **statutory authority** the information is demanded. If the demand for information is pressed without any statutory authority the professional accountant should seek the permission of the entity as to whether the information should be disclosed. If it is declined, legal advice may need to be sought. Any notice served directly to the professional accountant for obtaining documents related to the entity, the professional accountant should read carefully and seek legal advice if necessary.

A member should not voluntarily co-operate with the authorities by assisting with any investigations unless he acts with the entity's consent or is required to do so by law (see the three circumstances in which he is compelled to do so below). If he volunteers the information, it constitutes a breach of confidentiality.

From time to time a professional accountant may know or suspect that an entity has committed a wrongful act and in these circumstances he must give careful thought to his own position. Even in a criminal matter (excluding treason, money-laundering and terrorist offences), he is under no obligation to disclose his information to the relevant authority, but he must ensure that he has not prejudiced himself by, for example, relying on incorrect information.

However, the professional accountant may himself be chargeable with a criminal offence if he acted directly, without lawful authority or reasonable excuse, in such a manner as to impede with intent the arrest or prosecution of an entity whom he knows or believes to have committed an arrestable offence.

A member should not normally appear in court as a witness against an entity unless a written court order is served.

A member should seek legal advice to clarify the legal aspects of his position.

Voluntary disclosure. In certain cases voluntary disclosure may be made by the professional accountant:

- to protect the professional accountant's interests (for instance, to defend in litigation against him)
- where it is in the public's interest
- where it is authorised by statute
- to non-governmental bodies

HKICPA Code of Ethics for Professional Accountants

- to comply with technical standards and ethical requirements
- to comply with the quality review of a member or professional body
- to respond to an inquiry or investigation by a member body or regulatory body (i.e. disciplinary actions from HKICPA)
- to enable the firm to sue for its fee
- to resist an action for negligence brought against the professional accountant by an entity

Also, having decided that confidential information can be disclosed, professional accountants should consider:

- whether all relevant facts are known and substantiated
- what type of communication is expected and to whom it should be addressed
- whether the professional accountant will incur any legal liability as a result of disclosure

3.3 Disclosure in the public interest

The courts have never given a definition of “the public interest”. This means that again, the issue is left to the judgment of the professional accountant. It is often therefore appropriate for the member to seek legal advice.

It is only appropriate for information to be disclosed to certain authorities, for example, the police.

The HKICPA's *Code* states that there are several factors that the member should take into account when deciding whether to make disclosure.

HKICPA guidance

- The size of the amounts involved and the extent of likely financial damage
- Whether members of the public are likely to be affected
- The possibility or likelihood of repetition
- The reasons for the entity's unwillingness to make disclosures to the authority
- The gravity of the matter
- Relevant legislation, accounting and auditing standards
- Any legal advice obtained



Preparation comments

If you are required to make judgments about whether such a disclosure should be made in a given scenario, you should apply a checklist like this to the scenario to ensure you have shown evidence of your consideration of all the relevant factors.

3.3.1 Unlawful acts or defaults by or behalf of a member's employer

If a HKICPA member is aware that his employer or an agent may have committed an unlawful act, he should first draw it to the attention of **internal management at an appropriate level**. He may then report the offence to the board of non-executive directors, or if this option is not available, he may make a report to an external competent authority.

No general obligation exists for a professional accountant who becomes aware of a criminal or unlawful act to disclose this information to a third party without the prior authority from his employer. However, a HKICPA member has a general duty to his employer to act in good faith and with a duty of confidence.

The employed HKICPA member should not generally disclose any confidential information without the entity's consent.

Members' own relations with authorities: criminal offences

A member himself commits a criminal offence:

- (a) if he incites a client or anyone else to commit a criminal offence; or
- (b) if he helps or encourages a client or anyone else in the planning or execution of a criminal offence; or

- (c) if he agrees with a client or anyone else to pervert or obstruct the course of justice by concealing, destroying or fabricating evidence or by misleading the police by statements which he knows to be untrue.

Members are advised **not to attempt to avoid the awkward responsibility** of qualifying the report on the accounts by refusing to report and by resigning.

Members may find that they are requested in their professional capacity by the Independent Commission Against Corruption (ICAC) to assist in investigation of certain corruption allegations, mainly against their own clients. Such assistance usually is requested in the form of furnishing information to ICAC officers either orally or in writing.



Self-test question 3

You are the senior manager in a medium-size CPA firm. You are responsible for the audits for the following entity and you are reviewing the ethical issues attached to the engagement.

Johnco Co (Johnco) is a manufacturer of kitchen appliances which are exported all over the world.

The following matter has been brought to your attention by the audit senior, who has just completed the planning of the forthcoming audit for the year ending 31 March 20X0.

During a discussion with the production manager, it was revealed that there have been some quality control problems with the kitchen appliances manufactured in the middle of the year. It was discovered that some of the stainless steel used in the manufacture of the entity's products did not comply with the international quality standards. Johnco did not recall any of the products which had been manufactured during that time from customers, as management felt that the risk of any injury being caused was remote.

Required

Assess the ethical issues raised, and recommend any actions necessary, in respect of the stainless steel used by Johnco Co.

(The answer is at the end of the chapter)

4 Specific guidance: Conflicts of interest



Topic highlights

Professional accountants should identify potential conflicts of interest as they could result in ethical codes being breached.

A **conflict of interest** is a situation that may undermine the judgment of a professional accountant. There may be too much personally at stake either for himself or for his firm for the professional accountant to reconcile the stakeholders' or public interest against his own. In these situations:

- principles of independence, integrity and objectivity are not satisfied
- promoting personal interest may result in adverse consequences to stakeholders

Firms should take reasonable steps to identify circumstances that could pose a conflict of interest before they happen. A conflict of interest may result in the *Code* being breached (often conflicts of interest give rise to self-interest threats).

The key principle for the firm is that it firm **should not accept an engagement** in which there is likely to be a significant conflict of interest.

4.1 Conflicts between professional accountants' and entities' interests

A conflict between professional accountants' and entities' interests may arise if a firm of professional accountants are in direct competition with an entity, or else are involved in a joint venture with a one of the entity's competitors.

In the HKICPA *Code of Ethics* there are rules which state that **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**. This means any form of financial gain as a result of an engagement other than fees for work done will always constitute a significant conflict of interest.

Firms should evaluate the threats arising from a conflict of interest, and unless they are clearly insignificant, they should apply safeguards. The test of whether a threat is significant is whether a reasonable and informed third party, having knowledge of all relevant information, including the safeguards applied, would consider the conflict of interest as likely to affect the judgment and objectivity of the professional accountants involved.

Where any commission is earned by anyone in the firm for business introductions for advice the **this should be disclosed to the entity**. Special care should be taken that any advice given is in the entity's best interests.

4.2 Conflicts between the interests of different entities

There is nothing improper in a firm serving two or more entities whose interests are in conflict, as long as the work the firm is not the subject of the conflict.

Where the firm does act for two competing entities it must manage its work so that the interests of one entity do not adversely affect the entity. **Where acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any entity, the appointment should not be accepted or continued.**

Material prejudice may mean information being leaked or for firms to be forced into a corner where they have to choose between the interests of one entity or the other.

The firm must take all reasonable steps to evaluate whether any conflict exists, including implications arising from possession of confidential information and how this may be protected.

The firm should continually review its relationships with both prospective and existing entities before accepting or continuing engagements. If aware of possible conflicts between clients or potential clients, the firm should introduce safeguards to try to manage them.

If the relationship ended over two years before, it would be unlikely to constitute conflict.

Where material conflict of interest is identified, the firm should disclose sufficient information to the entity. It is then the decision of the entity as to whether to continue with the firm with the safeguards in place or to seek an alternative provider of the firm's services.

Particular difficulties can arise when it comes to share issues, and takeovers. Professional accountants are often rightly involved in either situation. With regard to **share issues**, firms should never underwrite an issue of shares to the public of an entity they audit. In a **takeover situation**, the professional accountants audit the accounts of both offer or and target company, they must ensure that do *not*

- act as the principal advisers to either party; or
- issue reports assessing the financial statements of either party other than their audit report

If they find they possess material confidential information, they should contact the competent authority.

4.2.1 Managing conflicts between entities interests

Disclosure is the most important safeguard in connection with conflicts of interests between entities. The following notifications would be among the safeguards used:

- (a) Disclosing to the entity of nature of the interests/activities that may cause a conflict and obtaining their permission to continue to act in the circumstances acknowledged.
- (b) Informing all known relevant parties that the firm is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent.
- (c) Seeking the entity's acknowledgement that the firm does not act exclusively for any one entity in the provision of the proposed services.

Other safeguards:

- Using separate engagement teams
- Procedures to prevent access of information (such as secure passwords and firewalls)
- Clear procedures for the respective teams on issues of security and confidentiality
- The use of confidentiality agreements signed by the partners and staff
- Regular review of the safeguards by an independent partner
- Advising one or both of the entities to obtain third party independent advice

If adequate disclosure is not possible due to confidentiality restrictions, the firm should not accept or continue the assignment.



Self-test question 4

You are an audit manager in MKJ & Co, a local CPA firm. Your firm has been approached by a new entity, Washington, which wants to engage your firm for both audit and advisory work.

Washington has expanded rapidly over the last few years and is planning to list in the next financial year. Washington's Financial Controller, Mr. Otto, is an old friend of one of your senior partners, Mr. Man.

Mr. Otto has indicated that if Washington can successfully list its shares, the taxation and consultancy work would be performed by your firm. Within your firm's portfolio, you have also an entity which is Washington's rival.

One of your audit seniors has resigned recently to take up the post as Human Resources Manager in Washington. Before any acceptance, Mr. Otto has invited your firm to join a very extravagant cocktail party. Washington will distribute its prospectus during the occasion.

Required

- (a) Identify and explain the ethical issues in the above situation.
- (b) Give three examples for safeguards within the firm to be used for reducing the threat to independence.

(The answer is at the end of the chapter)

5 Conflicts in application of the fundamental principles



Topic highlights

The *Code of Ethics* gives some general guidance to professional accountants who encounter a conflict in the application of the fundamental principles.

5.1 Matters to consider

The resolution process should include consideration of:

- relevant facts
- ethical issues involved
- fundamental principles related to the matter in question
- established internal procedures
- alternative courses of action

5.2 Unresolved conflict

If the matter is unresolved, the member should consult with other appropriate persons within the firm. They may wish to obtain advice from HKICPA or legal advisers.

If after exhausting all relevant possibilities, the ethical conflict remains unresolved, members should consider withdrawing from the engagement, a specific assignment, or members to resign altogether from the engagement.

6 Code of ethics applicable to professional accountants in business

Section C of the Code applies to professional accountants in **business**.

A professional accountant in business is a professional accountant employed or engaged in executive or non executive position.

He may be:

- a **salaried employee**, partner, director, owner, working for many organisations
- solely or jointly responsible for **preparing and reporting financial and other information** for their employers or any persons relying on the information
- responsible for providing effective financial management and competent advice for investors, creditors, employers or government departments
- has the responsibility to further **legitimate aims** of their employing organisation
- is expected to encourage an **ethics-based culture** and environment in an employing organisation that emphasises the importance of ethical values; and
- shall not knowingly engage in any business, occupation, or activity that impairs or might impair integrity, objectivity or the good reputation of the profession and as a result would be incompatible with the fundamental principles.

6.1 Examples of threats for professional accountants in business

The following are examples of threat to compliance with the fundamental principles for a professional accountant in business.

6.1.1 Self-interest threat

- Holding a financial interest in, or receiving a loan or guarantee from the employing organisation
- Participation in incentive compensation arrangements offered by the employing organisation
- Inappropriate personal use of corporate assets
- Consideration of employment security; and
- Commercial pressure from outside the employing organisation.

6.1.2 Self-review threat

Consideration of appropriate accounting treatment for a business combination after performing the research study that supported the acquisition decision.

6.1.3 Familiarity threat

- Where the professional accountant in business is responsible for the selection of the employing organisation's financial reporting when an immediate or close family member employed by the entity makes decisions that would affect the entity's financial reporting.
- Long association with business contracts affecting the business decisions, and
- A professional accountant in business accepts a material gift or hospitality, unless the value is trivial and inconsequential.

6.1.4 Intimidation threat

- **Threat of dismissal or replacement** of the professional accountant in business or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported, and
- The professional accountant in business with a **dominant personality** attempting to influence the decision making process.

6.1.5 Advocacy threat

When achieving the legitimate goals and objectives of their employing organisations, professional accountants in business may promote the organisation's goals. If the statements made are neither false nor misleading, the actions would not create an advocacy threat.

6.2 Safeguards to comply with the fundamental principles for professional accountants in business

Two types of safeguards are available:

- Safeguards created by the profession, legislation or regulation, and
- Safeguards in the working environment.

These include the following:

- The employing **organisation's systems of corporate oversight** or other oversight structures
- The employing organisation's ethics and conduct programmes
- Recruitment procedures in the employing organisation emphasising the importance of employing highly competent staff
- Implementing strong internal controls
- Appropriate disciplinary processes
- Strong leadership to emphasise the importance of ethical behaviour and expecting employees to act ethically at all times
- Set policies and procedures to implement and monitor quality of employee
- Update employees with any changes in policies and procedures
- Appropriate training education in implementing such policies
- Set policies and procedures to encourage each employee to communicate to senior levels within the employing organisation; and
- Consult another professional accountant.

6.3 Potential conflicts

A professional accountant in business is expected to support ethical and legitimate objectives established by the employer and the employer's established rules and procedures. Sometimes, there might be conflict in between a professional accountant's responsibilities to an employing organisation and professional obligations to comply with the fundamental principles.

The professional accountant in business may be under **pressure** to:

- act contrary to law or regulation, technical or professional standards
- facilitate unethical or illegal earnings management strategies
- lie to or intentionally mislead others such as auditors or regulators, and
- issue or be associated with a financial or non-financial report that materially misrepresents the facts.

Safeguards **available to eliminate the threat or reduce it to an acceptable level:**

- Obtain advice from the employing organisation, an independent professional adviser or a relevant professional body
- The existence of a formal dispute resolution process within the employing organisation, and
- Seek legal advice.

6.4 Preparation and reporting of information

A professional accountant in business should prepare or present financial and other information **fairly, honestly and comply with professional standards** so that the information will be understood in its context.

A professional accountant in business shall maintain information for which the professional accountant is responsible so that the information:

- describes clearly the true nature of business transactions, assets and liabilities;
- classifies and records information in a timely and proper manner, and
- represents the facts accurately and completely in all material respects.

When a professional accountant in business is pressured to become associated with **self-interest or intimidation threats** (for example, misleading information or misleading information through the actions of others) **safeguards** may be put in place such as:

- **consultation with superiors** within the employing organisation or with a relevant professional body.

If it is not possible to apply safeguards, the professional accountant should refuse to remain in association with the information they consider to be unsafe. The professional accountant may also consider resignation.

6.5 Acting with sufficient expertise

A professional accountant in business **should not intentionally mislead an employer** as to the level of expertise or experience possessed and should seek appropriate advice and assistance when required.

Circumstances when there is a threat to the performance of duties with the appropriate degree of competence and due care are:

- insufficient time for properly performing or completing the relevant duties
- incomplete, restricted or otherwise inadequate information for performing the duties properly
- insufficient training, experience and education, and

- inadequate resources for the proper performance of the duties.

Safeguards **available to eliminate the threat or reduce it to an acceptable level:**

- Obtain additional advice and training
- Ensure sufficient time to complete duties, and
- Consult, where appropriate, superior, independent experts, regulatory and professional body.

When threats cannot be eliminated or reduced to an acceptable level, professional accountants in business shall determine whether to refuse to perform the duties in question.

6.6 Financial interests

Professional accountants in business or their immediate or close family members may face self-interest threats which would create a threat to objectivity.

Situations which may pose a problematic financial interest include the following:

- Holds a **direct or indirect financial interest** in the employing organisation and the value of the financial interest could be directly affected by decisions made by the professional accountant
- Eligible for a **profit related bonus** which could be directly affected by the professional accountant's decisions
- Holds directly or indirectly **share options** in the employing organisation which will be converted, and
- Share options will be qualified when performance targets are met in the employing organisation.

Safeguards **available to eliminate the threat or reduce it to an acceptable level:**

- Disclose all relevant interests and any future plans to trade in relevant shares, to those charged with governance
- Set policies and procedures and an independent committee to determine the level or form of remuneration of senior management
- Consult, where appropriate, with a superior, independent experts, regulatory and professional bodies or, those charged with governance
- Internal and external audit procedures, and
- Up-to-date education on ethical issues and the legal restrictions and other regulations around potential insider trading.

A professional accountant in business shall neither manipulate information nor use confidential information for personal gain.

6.7 Inducements

Inducements would cause **a self-interest threat and an intimidation threat**. The professional accountant in business or their immediate close family member may be offered, or may offer, inducements such as gifts, hospitality or any other preferential advantages.

Receiving an offer

The **self-interest threat** (or confidentiality) occurs when an inducement is made in an attempt to:

- unduly influence actions or decisions
- encourage illegal or dishonest behaviour, and
- obtain confidential information.

An **intimidation threat** (or breach of confidentiality) will occur when an inducement is accepted and followed by threats to make that offer public and damage the reputation of the professional accountant in business or his immediate family members.

There is no significant threat to compliance with the fundamental principles if the offer is made in the normal course of business.

The inducement shall not be accepted when the threats cannot be eliminated or reduced to an acceptable level through the application of safeguards.

Making an offer

A professional accountant in business **should not offer an inducement** to improperly influence the professional judgment of a third party.

When an unethical inducement is offered from the employing organisation, the professional accountant should follow the principles and guidance regarding ethical behaviour.

Actions to be taken when there is an inducement offered:

- Inform higher levels of management or those charged with governance
- Inform third parties of the offer – ie a professional body, and
- Advise immediate or close family members of the situation after receiving such inducements.



Self-test question 5

DEF is a company incorporated in Hong Kong. It is listed on the Hong Kong Stock Exchange. The principal activities of the company are property investment, management and development. Mr. Chan, DEF's Chief Executive Officer ("CEO"), Chairman of the Board and major shareholder, has asked Simon, FCPA and DEF's financial controller, to falsify certain documents and accounting records of DEF so that Mr. Chan can misappropriate \$1 billion of DEF's cash for his personal investments. Mr. Chan promises to pay back the \$1 billion to DEF in a month and indicates that he will give Simon a very favourable assessment for Simon's bonus and promotion evaluation for the current year; otherwise, he will replace Simon with someone who will work better with him.

Required

Based on the information given above:

- (a) Comment on the ethical issues; and (5 marks)
- (b) Outline the possible actions Simon would need to take to address these ethical issues.

(5 marks)

(Total = 10 marks)

HKICPA May 2009

(The answer is at the end of the chapter)

7 Other issues

7.1 Client acceptance



Topic highlights

Before accepting a **new engagement**, the professional accountant in public practice should consider whether **there is any threat to compliance with the fundamental principles**, that is any potential threats to integrity or professional behaviour, for example, entity involvement in illegal activities

The significance of any threats should be evaluated and safeguards should be applied to eliminate them or reduce them to an acceptable level.

If it is not possible to reduce the threat to an acceptable level, the professional accountant in public practice should decline the engagement.

For recurring entity engagement, acceptance decisions should be reviewed annually.

7.2 Engagement acceptance

A professional accountant must only accept engagement that he is **competent to perform** and safeguards may be applied:

- Obtain appropriate understanding of the **nature of the client's business**, complexity of the operations, specific requirement of the engagement, the relevant industries and the scope of work
- Obtain and be **familiar with the relevant regulations** or reporting requirement
- Assigning **sufficient competent staff**
- Consider the use of **experts**
- Consider the **deadline**, and
- Comply with quality control policies and procedures to provide reasonable assurance that specific engagements are accepted only when they can be performed competently.

7.3 Changes in professional appointment

A professional accountant should determine whether there are any reasons for not accepting the engagement. Safeguards may be applied such as the following:

- Discuss client's affairs with existing accountant
- **Enquire of the existing accountant** regarding information of which the proposed accountant needs to be aware before deciding whether to accept the engagement
- Before any initiation to contact the existing accountant, there must be client's consent; and
- Any client's information to be released by the existing client, must be with the client's consent or there must be a legal or ethical requirement for such disclosure.

7.4 Marketing professional services

The professional accountant should be honest and truthful and should not exaggerate any claims of services offered, qualifications and experience or make disparaging references about the work of another professional accountant.

7.5 Custody of entity's assets

A professional accountant should not keep, in custody, the entity's monies or other assets unless permitted to do so. If the professional accountant, for instance, is entrusted with money or other assets belonging to others, the following safeguards should be applied:

- Keep it separately from personal and firm's assets
- Only use the assets for intended purpose
- Keep proper accounting records for the assets
- Comply with laws and regulations

7.6 Integrity, objectivity and independence in insolvency

Receivership and liquidator appointment

When a material professional relationship with an entity exists, no partner in or employee of the firm should accept appointment as receiver or as receiver and manager of that entity or liquidator of the entity if the entity is insolvent or a trustee in bankruptcy.

A material professional relationship

Partner/employee of the firm is prohibited from appointment as receiver, manager, liquidator or trustee if there has been a material professional relationship during the previous two years.

Material professional work

Audit work of such overall significance that a member's objectivity in carrying out a subsequent insolvency appointment could be or could reasonably be prejudiced.

If the company goes into liquidation the company's rights remain **vested** in the company.

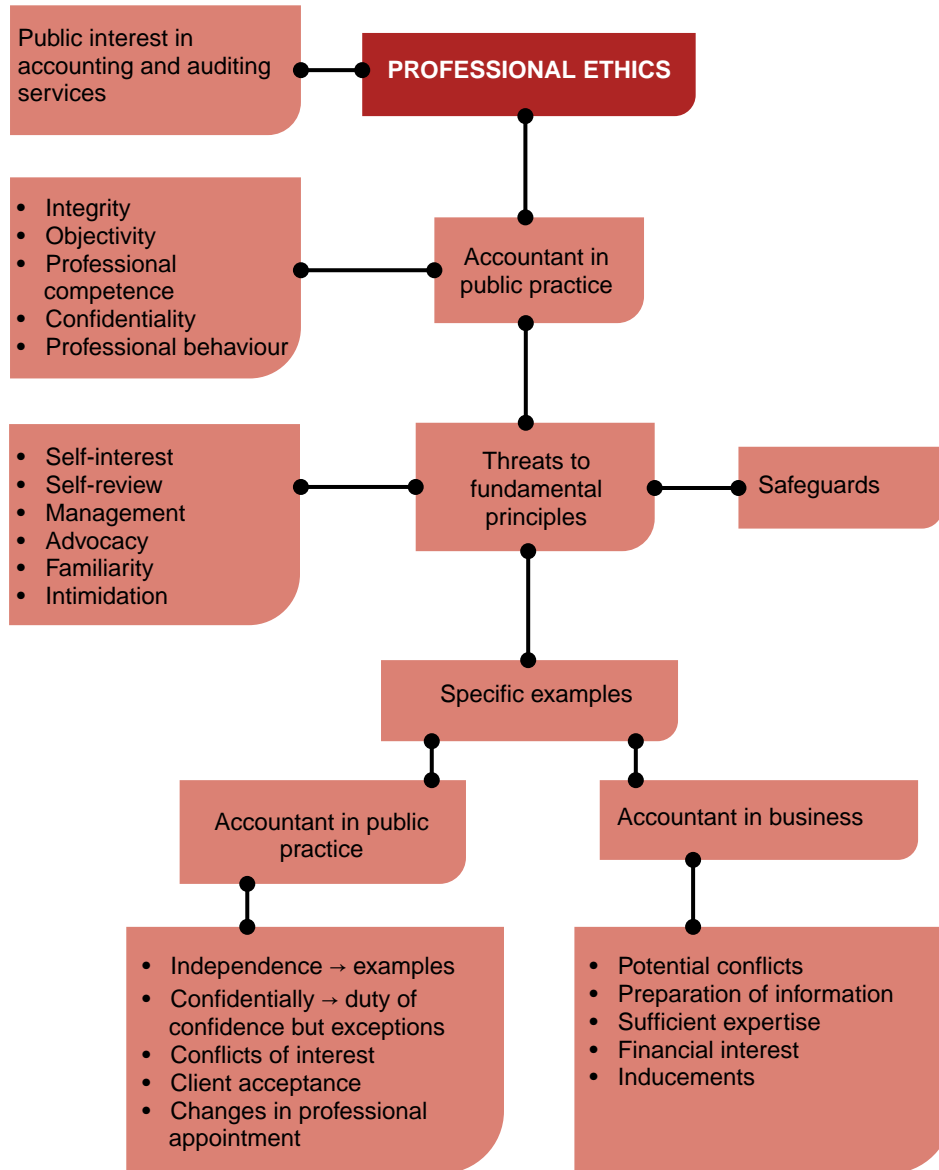
The auditor of a company which is in liquidation may be **approached by the police for assistance in inquiries (still need to consider confidentiality)**.

Audit following receivership

Where a partner in or an employee of a practice has been receiver of any of the assets of a company, neither the practice nor any partner in or employee of the practice should accept appointment as auditor of the company, or of any company which was under the control of the receiver, for any accounting period during which the receiver acted or exercised control.

Acceptance of an insolvency appointment in relation to more than one company in a group of companies or association may raise issues of **conflict of interest**.

Topic recap



Answers to self-test questions

Answer 1

- (a) In accordance with Code of Ethics the relevant threats to independence in this case relating to acceptance of a loan are: **self-interest threat and familiarity threat.**

The **self-interest threat** occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client, such as a loan or guarantee to or from an assurance client or any of its directors or officers.

The **familiarity threat** occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests, such as by acceptance of gifts or hospitality, unless the value is clearly insignificant, from the assurance client, its directors, officers or employees.

The revised *Code* requires that if a member of the assurance team or his/her immediate family member has a material indirect financial interest in the assurance client, the self-interest threat created would be so significant that the only safeguards available to eliminate the threat or reduce it to an acceptable level would be:

- disposal of the indirect financial interest in total;
- disposal of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team; or
- removal of the member of the assurance team from the assurance engagement.

Similarly, there would be no problem if the client, whose normal course of business was to lend, lent to audit staff members on normal commercial terms. However, the offer is a benefit to audit and other firm staff, as the interest rate would be significantly below the market rate. This puts it within the context of the guidelines on gifts and hospitality, because, although strictly, it is neither, it is a benefit to staff.

Regarding gifts and hospitality, Audit staff members are entitled to accept gifts or hospitality of trivial or inconsequential value. Clearly, what is considered trivial will vary from person to person according to his circumstances.

However, it is important to note at this point, that, whatever the circumstances of individuals are, the firm should decide on a rule that applies to all staff, and should not create a situation where some staff members are entitled to the benefit and others are not.

When considering whether a benefit is trivial, the firm must consider the materiality of the benefit to each recipient, or, in other words, the recipient to whom it would be least trivial.

In this question, the low rate would apply to the individuals over a number of years, and represents a significant discount, much greater than that generally available to the public.

The amount is therefore unlikely to be trivial. As such, Kwok & Co should conclude that to accept such a benefit would represent a significant threat to the objectivity of the firm, through its staff, in relation to the audit, and should refuse the offer.

Regarding accepting loans, the audit firm could accept a loan from a client whose normal course of business is lending on normal commercial terms. In such circumstance, it might be wise for the audit firm to consider the need to put additional safeguards in place.

- (b) The **audit partner** should consider the following issues:

First, as an employer, he should consider whether Kwok & Co wants to retain the benefit of the training costs they have incurred to date in respect of the trainee and try to encourage the audit assistant to stay.

Second, in terms of **audit objectivity and independence**, the partner should consider whether he should take any steps in relation to the audit of Kowloon Bank should the trainee work there. The partner should consider:

- the seniority of the engagement team member;
- the nature of the role he would take up at Kowloon Bank; and
- the need to amend the audit plan and approach for future audits.

As the audit assistant was only a junior member of the engagement team, it is unlikely that the audit partner would need to take any steps. However, if the audit assistant is moving to the bank's finance department, rather than the general business, the audit partner may decide to review the approach as a precaution, particularly if the audit assistant has seen the upcoming audit plan and strategy.

Answer 2

- (a) Section 290 of the *Code of Ethics* provides specific guidance on independence requirements for audit and review engagements. Independence requires independence of mind and independence in appearance.

Independence of mind is the state of mind that permits the expression of an opinion without being affected by influences that compromise professional judgment, 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 specific facts and circumstances, that a firm's or a member of the engagement team's integrity, objectivity or professional scepticism have been compromised.

The provision of non-assurance services to assurance clients may create threats to the independence of the firm, particularly with respect to perceived threats to independence (independence in appearance).

Consequently, it is necessary to evaluate the significance of any threat created by the provision of such services.

In some cases, it may be possible to eliminate or reduce the threat created by the application of safeguards. In other cases no safeguards are available to reduce the threat to an acceptable level.

- (b) A valuation comprises the making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value for an asset.

A self-review threat may be created if Yu & Yu performs a valuation for the assets of La'Monsa that are to be incorporated into the financial statements for the year ended 31 December 20X6.

If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self review threat could not be reduced to an acceptable level by the application of any safeguard. Accordingly, such valuation services should be not provided; alternatively, the only course of action would be to withdraw from the financial statement audit engagement.

If the brand and the machinery and equipment are material, Yu & Yu cannot accept the engagement to provide valuation services unless they withdraw from the financial statement audit engagement.

It is not easy to quote a market price for the brand. The valuation may involve a significant degree of subjectivity in the assumptions regarding future developments of the business after merger with another company. It is not advisable to accept the valuation of the brand for La'Monsa.

If the services are neither material to the financial statements nor involving a significant degree of subjectivity, the self-review threat could be reduced to an acceptable level by the application of safeguards.

The net realisable value of plant and machinery can be quoted from the market. If the value of the machinery and equipment is not material, and net realisable value rather than value in use (which entails a significant degree of subjectivity in the assumptions regarding future developments of the business after merger with another company) is adopted in the valuation, Yu & Yu could reduce the self-review threat by applying the following safeguards:

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary;
- Obtaining La'Monsa's acknowledgement of responsibility for the results of the work performed by Yu & Yu; and
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

Answer 3

Management has decided not to recall any products and this indicates problems with management integrity. The defects in the products have potential effects on Johnco's customers. It would still be ethically appropriate to announce the problem, allowing customers to return potentially harmful products. There might be still inventories that are defected in Johnco's warehouses, waiting to be sold. Professional accountants should try to explain to management the reasons why they should disclose and should convince management that this is the way to proceed.

If management still refuse to make a disclosure, the professional accountants should consider their obligatory duty of confidentiality. The HKICPA's *Code of Ethics* recognises that information discovered while performing a professional engagement must not be disclosed without the entity's consent unless there is a legal or professional right or duty to disclose.

In deciding whether to disclose in the public interest, the professional accountants should consider the reasons for the entity's unwillingness to disclose, the materiality of the matter ie the probability of harm being caused to the customers, and the relevant laws and regulations being breached.

The professional accountants could consider the option of resigning from the audit. The firm could inform audit committee or board of directors the reason for the resignation, including details of the faulty products, disagreements with the management and the lack of management integrity.

Finally, the lack of management integrity also affects on the nature, extent and timeliness of audit procedures that are currently being planned. Any defective inventory still held by Johnco should be written off as obsolete goods, and provisions may be necessary for refunds of returned products or future claims by customers. The financial statements may need to contain disclosures relating to contingent liabilities, or provisions may need to be recognised in respect of damages claimed by customers in the event of any injuries occurring and legal action being taken against Johnco.

Answer 4

(a) Washington – ethical issues

In accordance with the *Code of Ethics*, MKJ & Co should consider ethical issues in its entity acceptance procedures. In considering accepting Washington as its client entity, MKJ & Co should consider any relevant threats to independence which may impair the firm's objectivity and independence.

Self-interest threat

There are no details mentioned regarding the fee income obtained from Washington. However, as Washington will soon list, MKJ should ensure no more than 10% of its recurring practice income (assuming advisory work, taxation and consultancy work to be performed annually) should be derived from Washington. Obtaining over 10% could indicate undue dependence on an entity and objectivity would be likely to be impaired resulting in a self-interest threat.

MKJ & Co should review its proposed fee and should consider whether it should limit other services so that independence is not impaired. An annual review would be required on Washington if the fee is close to 10% of its total fee.

Self-review threat

A self review threat may be created when MKJ & Co provides advisory work and consultancy work for Washington, especially when the works are on financial accounting.

Familiarity threat

The familiarity threat may occur when there exists a close relationship with an entity, its directors, officers or employees; a firm or a member of the assurance team becomes too sympathetic to the entity's interest.

In accordance with the facts, Mr. Otto, Washington's Financial Controller is an old friend of one of the senior partners, Mr. Man. The firm should consider whether a different partner should take the lead on Washington's work.

Conflict of interest

Within MKJ & Co's portfolio, there is an entity who is also a competitor of Washington. There is nothing improper in a firm having two or more entities whose interests are in dispute, as long as the work the firm does is not the subject of the dispute.

In this case, MKJ & Co's work should be managed so as to avoid the interests of one entity adversely affecting the other. The firm should review its relationship with prospective entity ie Washington and the rival entity before accepting/continuing the engagement. If a material conflict of interest is identified, the firm should disclose sufficient information to entities so that they can make an informed decision as to whether to continue with the firm.

Advocacy threat

Since Washington is about to list, if MKJ & Co agrees to attend the cocktail party, there may be threats to independence through an advocacy threat. This occurs when the firm may be perceived to be a promoter of shares in Washington, as the prospectus is being distributed during the party. The firm should consider how likely this perception is, for example, whether their name appears on the prospectus or the party invitation. In addition, they should consider whether hospitality at an "extravagant cocktail party" is "clearly insignificant".

(b) **Safeguards**

Self-interest threat – fee

MKJ & Co should start monitoring when the fee is approaching 10% of its total fee of the firm. If there is undue dependence on Washington, MKJ should be selective of the engagements.

MKJ & Co should install appropriate safeguards especially the firm should not act in the management role, making managerial decisions. The rule should be strictly complied with as Washington will be listed in next financial year.

Familiarity threat

A familiarity threat may have been created. Mr. Man should not be assigned as the engagement partner on the audit.

One of the audit seniors has become an employee of Washington, however since the employee is to become Human Resources Manager, there is very little direct and significant influence over the financial accounting aspect. MKJ & Co may instruct the partner in charge to modify the audit plan normally used as a safeguard, but this appears to be an insignificant risk.

Conflicts of interest

Some of the most common safeguards to manage this conflict of interest would be using different engagement teams to handle Washington's work and its rival's work. The firm should have standing instructions to prevent the leakage of confidential information or prevent access to information.

Advocacy threat

MKJ & Co should not participate in any activities relating to the promotion of the shares of Washington and should make clear to Washington's management that they cannot be perceived to.

Answer 5

(a) Ethical issues

Since Simon is a salaried employee of DEF, Simon is a professional accountant in business and is required to comply with the Code of Ethics for Professional Accountants.

A professional accountant in business should prepare or present financial and other information fairly, honestly and in accordance with relevant professional standards.

Financial and non-financial information should be maintained in a manner that describes clearly the true nature of business transactions, assets or liabilities and classifies and records entries in a timely and proper manner.

Self-interest or intimidation threats may occur where a professional accountant in business may be pressured (either externally or by the possibility of personal gain) to become associated with misleading information or to become associated with misleading information through the actions of others.

In this case, Mr. Chan's request for Simon to falsify certain documents and accounting records of DEF in return for a favourable assessment for Simon's bonus and promotion evaluation for the current year represents a self-interest threat.

Also, Mr. Chan's threat to replace Simon if Simon does not accede to the request represents an intimidation threat.

(b) Actions to be taken

Since Mr. Chan is the CEO and major shareholder of DEF, it is inappropriate to report the fraud or suspected fraud to other senior management who are actually Mr. Chan's subordinates.

As Mr. Chan is also the Chairman of the board of directors, reporting the matter to the Chairman of the board of directors might not be desirable for Simon either.

DEF is a listed company and all listed companies in Hong Kong are required to establish an audit committee, of which the Chairman should be an independent non-executive director.

Simon should thus report the matter to the Chairman of the audit committee.

As a last resort, Simon may consider making a report to an appropriate external authority such as the police or the ICAC in line with the ethical guidance on the duty of confidentiality.

When in doubt, Simon is recommended to seek legal advice.

Simon should be aware that he himself commits a criminal offence if he helps Mr. Chan in the planning or execution of his plan to misappropriate DEF's \$1 billion cash.

Simon should also be aware that he may incur civil liability to third parties if he is involved in Mr. Chan's unlawful conduct by assisting him in the planning or execution of the unlawful conduct.

Exam practice

**DEL****21 minutes**

Carol is a CPA working in Yvonne & Zoe CPA (“Y&Z”) as a manager in charge of the audit of Daisy Emma Limited (“DEL”) for the year ended 30 June 20X1. DEL, which is not a public interest entity, has recently offered Carol a part-time position as the company secretary to commence as soon as possible.

Carol accepts DEL’s offer this week on the grounds that she will only be required to carry out routine administrative services to support the corporate secretarial function and to make decisions in respect of corporate secretarial matters at the annual general meeting. In addition, Carol considers that Y&Z’s audit report on DEL’s financial statements will be signed by her audit partner, and Carol is not an audit partner at Y&Z.

Having been formally appointed as DEL’s company secretary this week, Carol thinks she ought to discuss the matter with Yvonne (who is Y&Z’s partner in charge of the audit of DEL) in order to implement certain safeguards just in case of any possible conflict of interest.

Required

- (a) Analyse the situation of Carol in the context of the HKICPA’s ethical requirements. **(8 marks)**
- (b) Discuss any safeguards or actions Yvonne could implement in order to reduce the threats against the HKICPA’s ethical requirements to an acceptable level. **(4 marks)**

(Total = 12 marks)**HKICPA June 2012**



chapter 5

Framework for assurance engagements

Topic list

- 1 Overview of the Hong Kong Framework for Assurance Engagements**
 - 1.1 Hong Kong Framework for Assurance Engagements
 - 1.2 Adherence to professional standards and guidance
- 2 Assurance engagements**
 - 2.1 Purposes of an assurance engagement
 - 2.2 Elements of an assurance engagement
 - 2.3 Assurance engagement or not?
 - 2.4 Types of assurance engagements
 - 2.5 Accepting and continuing appointment
- 3 The purpose of external audit engagements**
 - 3.1 Objective of external audit
 - 3.2 Materiality
 - 3.3 Professional scepticism
- 4 Reviews and other assurance engagements**
 - 4.1 Review engagements
 - 4.2 Assurance engagements not dealing with historical financial information
 - 4.3 Investment circular reporting engagements
- 5 Non-assurance engagements**

Learning focus

This chapter explains the basis of auditing and the distinction between audit and other review assignments. Students are expected to know the *Framework* that governs these assurance engagements.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
1.02	Professional standards and guidance	3
1.02.01	Explain the importance of adherence to professional standards and guidance	
1.03	Legal and regulatory framework governing the profession	3
1.03.01	Explain the regulatory framework for assurance and non-assurance engagements in Hong Kong	
1.03.02	Explain the nature and purpose of assurance and non-assurance engagements	

1 Overview of the Hong Kong Framework for Assurance Engagements



Topic highlights

HKICPA has adopted the Clarity standards issued by IAASB.

The Hong Kong Institute of CPAs (HKICPA) is pursuing a policy of achieving convergence with International Standards issued by the International Auditing and Assurance Standards Board (IAASB). Hong Kong Clarified Pronouncements on Auditing are issued in response to the IAASB's Clarity Project to improve the understandability of auditing standards.

The following table shows the list of Hong Kong Standards on Quality Control, Auditing, Assurance and Related Services in issue at 31 May 2013:

Hong Kong Standards on Auditing

Preface

Preface (Revised)	Preface to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services
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Glossary

Glossary (Clarified)	Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services
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Hong Kong Standards on Quality Control (HKSQCs)

HKSQC 1 (Clarified)	Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements
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Hong Kong Framework for Assurance Engagements

Framework	Hong Kong Framework for Assurance Engagements
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Hong Kong Standards on Auditing (HKSAAs)

HKSA 200 (Clarified)	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing
HKSA 210 (Clarified)	Agreeing The Terms of Audit Engagements
HKSA 220 (Clarified)	Quality Control for an Audit of Financial Statements
HKSA 230 (Clarified)	Audit Documentation
HKSA 240 (Clarified)	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
HKSA 250 (Clarified)	Consideration of Laws and Regulations in an Audit of Financial Statements
HKSA 260 (Clarified)	Communication with Those Charged with Governance
HKSA 265 (Clarified)	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
HKSA 300 (Clarified)	Planning an Audit of Financial Statements
HKSA 315 (Revised)	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
HKSA 320 (Clarified)	Materiality in Planning and Performing an Audit
HKSA 330 (Clarified)	The Auditor's Responses to Assessed Risks
HKSA 402 (Clarified)	Audit Considerations Relating to an Entity Using a Service Organisation

Hong Kong Standards on Auditing

HKSA 450 (Clarified)	Evaluation of Misstatements Identified during the Audit
HKSA 500 (Clarified)	Audit Evidence
HKSA 501 (Clarified)	Audit Evidence – Specific Considerations for Selected items
HKSA 505 (Clarified)	External Confirmation
HKSA 510 (Clarified)	Initial Audit Engagements – Opening Balances
HKSA 520 (Clarified)	Analytical Procedures
HKSA 530 (Clarified)	Audit Sampling
HKSA 540 (Clarified)	Auditing Accounting Estimates, including Fair Value Accounting Estimates and Related Disclosures
HKSA 550 (Clarified)	Related Parties
HKSA 560 (Clarified)	Subsequent Events
HKSA 570 (Clarified)	Going Concern
HKSA 580 (Clarified)	Written Representations
HKSA 600 (Clarified)	Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)
HKSA 610 (Revised)	Using the Work of Internal Auditors
HKSA 620 (Clarified)	Using the Work of an Auditor's Expert
HKSA 700 (Clarified)	Forming an Opinion and Reporting on Financial Statements
HKSA 705 (Clarified)	Modifications to the Opinion in the Independent Auditor's Report
HKSA 706 (Clarified)	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
HKSA 710 (Clarified)	Comparative Information – Corresponding Figures and Comparative Financial Statements
HKSA 720 (Clarified)	The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
HKSA 800 (Clarified)	Special Considerations – Audit of Financial Statements Prepared in Accordance with Special Purpose Framework
HKSA 805 (Clarified)	Special Consideration – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
HKSA 810 (Clarified)	Engagements to Report on Summary Financial Statements

Hong Kong Standards on Review Engagements (HKSREs)

HKSRE 2400 (Revised)	Engagements to Review Historical Financial Statements
HKSRE 2410	Review of Interim Financial Information Performed by the Independent Auditor of the Entity

Hong Kong Standards on Assurance Engagements (HKSAEs)

HKSAE 3000	Assurance Engagements Other than Audits or Reviews of Historical Financial Information
HKSAE 3402	Assurance Report on Controls at a Service Organisation
HKSAE 3410	Assurance Engagements on Greenhouse Gas Statements
HKSAE 3420	Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus

Hong Kong Standards on Auditing

Hong Kong Standards on Related Services (HKSRs)

HKSRS 4400	Engagements to Perform Agreed-Upon Procedures Regarding Financial Information
HKSRS 4410 (Revised)	Compilation Engagements

Hong Kong Standards on Investment Circular Reporting Engagements (HKSIRs)

HKSIR 300	Accountants' Reports on Pro Forma Financial Information in Investment Circulars
HKSIR 400	Comfort Letters and Due Diligence Meetings on Financial and Non-Financial Information

These standards will be referred to later in this Learning Pack when detailed auditing issues are introduced.

1.1 Hong Kong Framework for Assurance Engagements

The *Hong Kong Framework for Assurance Engagements* (“the *Framework*”) defines and describes the elements and objectives of an assurance engagement. The *Framework* provides a frame of reference for professional accountants in public practice when performing assurance engagements.

Professional accountants are governed by the *Code of Ethics* and HKSQCs.

1.2 Adherence to professional standards and guidance

It is important for professional accountants to adhere to professional standards and guidance such as the *Code of Ethics* (“the *Code*”), the Hong Kong Standards on Auditing (“HKSA”) or the Hong Kong Standards of Quality Control (“HKSQC1”) as professional accountants are seen to serve in the public interest.

HKICPA is the statutory licensing body of CPAs in Hong Kong. It is recognised globally and is in a position to strengthen the accountancy profession and to contribute to the development of strong international economies by establishing and promoting adherence to high-quality professional standards, furthering the international convergence of such standards and speaking out on public interest issues where the profession’s expertise is most relevant.

Professional accountants are obliged to adhere to these values, which are reflected in the *Code of Ethics*. By complying with professional standards, professional accountants contribute to the efficient functioning of the economy by:

- improving confidence in the quality and reliability of financial reporting;
- encouraging the provision of high quality performance information (financial and non-financial) within entities;
- promoting the provision of high quality services by all members of the accountancy profession; and
- promoting the importance of adherence to the *Code* by all members of the accountancy profession, including members in industry, commerce, the public sector, the not-for-profit sector, academia, and public practice.

2 Assurance engagements



Topic highlights

Assurance engagements may give reasonable assurance or limited assurance.

2.1 Purposes of an assurance engagement

The purposes of an assurance engagement can be defined as to:

- (a) **express a conclusion** that provides an intended user with a **level of assurance** about the **subject matter**
- (b) enhance **credibility** of information about a subject matter by evaluating whether the subject matter conforms in all material aspects with suitable criteria
- (c) improve likelihood that information will **meet the needs** of an intended user

2.2 Elements of an assurance engagement

The definition of an assurance engagement is set out in the key term below. You should be familiar with it.

HK Framework for Assurance Engagements.7



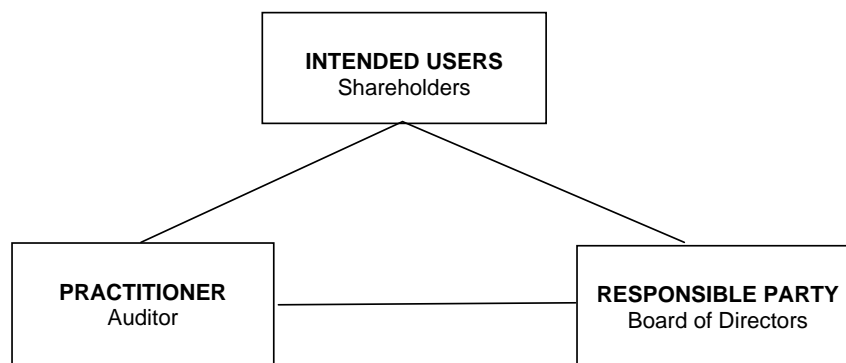
Key term

An **assurance engagement** is an engagement in which 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. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to the subject matter.

2.3 Assurance engagement or not?

2.3.1 A three party relationship

An assurance engagement must involve a three party relationship and they are: practitioner, responsible party and intended users. For example, in an audit, it involves:



Auditors (the practitioners) provide assurance to intended users (shareholders) about a subject matter (the financial statements) that is the responsibility of a responsible party (the board of directors).

The **intended user** is the person for whom the auditors prepare a report for a specific use or purpose – usually the shareholders and others users that can be established by law.

The “**responsible party**” is the person (or persons) who is responsible for the subject matter (in a direct reporting engagement) or subject matter information of the assurance engagement.

(Refer also to B Kwok in his book, *Financial Analysis in Hong Kong*, for the tripartite relationship of audit.)

2.3.2 Subject matter

Subject matter should be:

- identified
- located in a point in time or covering a period of time
- in the form of either data, systems and processes or behaviour
- in respect of financial or non-financial performance, systems or behaviour

2.3.3 Suitable criteria

Criteria should have the following characteristics:

- (a) **Relevance:** relevant criteria contribute to conclusions that assist decision-making by the intended users.
- (b) **Completeness:** criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted. Complete criteria include, where relevant, benchmarks for presentation and disclosure.
- (c) **Reliability:** reliable criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.
- (d) **Neutrality:** neutral criteria contribute to conclusions that are free from bias.
- (e) **Understandability:** understandable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.

2.3.4 Sufficient appropriate evidence

The practitioner plans and performs an assurance engagement with professional scepticism in order to obtain sufficient appropriate evidence about whether the subject matter is free from material misstatements. The practitioner considers materiality, assurance engagement risk, and the quantity and quality of available evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of evidence gathering procedures.

'Sufficiency' is about the **quantity** of evidence.

'Appropriate' is about **quality** of evidence (relevance and reliability).

2.3.5 Written assurance report

An assertion-based engagement is the evaluation of the subject matter in the form of assertions made by the responsible party.

In the context of a **direct reporting engagement**, this is where the reporting party expresses a conclusion on the subject matter based on suitable criteria, regardless of whether the responsible party has made a written assertion on the subject matter, for example, a report on the effectiveness of internal control process.

2.3.6 Assurance engagement risk

This risk is defined as “risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated”.

The components of assurance engagement risk are:

Inherent Risk + Control Risk + Detection Risk

Inherent risk: the susceptibility of the subject matter information to a material misstatement, assuming that there are no related controls.

Control risk: the risk that a material misstatement that could occur will not be prevented, or detected and corrected, on a timely basis by related internal controls. When control risk is relevant to the subject matter, some control risk will always exist because of the inherent limitations of the design and operation of internal control.

Detection risk: the risk that the practitioner will not detect a material misstatement that exists. We shall look at the above risks in more detail in Chapter 8.

2.4 Types of assurance engagements



Topic highlights

HKSAE
3000.2

HKSAE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information* refers to two types of engagement: “reasonable assurance engagement” and “limited assurance engagement”. Remember that absolute assurance can **never** be given on an assurance engagement due to the **inherent limitations** of such engagements.

“Assurance” here means **the professional accountants' satisfaction as to the reliability of the assertion made by one party for use by another party.**

2.4.1 Reasonable level of assurance

Reasonable assurance is **accumulating evidence** for the practitioner to conclude in relation to the subject matter information **taken as a whole.**



Key term

Reasonable assurance in the context of an audit of financial statements is a high, but not an absolute, level of assurance.

HKSA
200.13m

Professional accountants have gained sufficient appropriate evidence to conclude the subject matter conforms in all material aspects with identified suitable criteria. Professional accountants should design the engagement so that the risk of **expressing an inappropriate conclusion** that the subject to reduce risk of inappropriate conclusion respects with suitable criteria is reduced to an acceptably **low level.** Reasonable assurance relates to the whole audit process.

For example, an **audit** provides a reasonable assurance level but **not absolute** assurance and the report contains a **positive assurance** on assertions for example, “the financial statements give a true and fair view of ...”.

2.4.2 Limited level of assurance

Professional accountants should gain sufficient appropriate evidence to be satisfied that subject matter is plausible in the circumstances. Auditors should design the engagement so that the risk of **expressing an inappropriate conclusion** that the subject to reduce risk of inappropriate conclusion respects with suitable criteria is reduced to limited level.

For example: A **review** provides **limited** assurance that the information subject to review is free of material misstatement. The review is expressed in the form of **negative assurance (HKSRE 2400 (Revised)).**

Negative assurance is defined as “The professional accountant gives an assurance that **nothing has come to his attention** which indicates that the financial statements have not been prepared according to the framework.” (For example: “nothing has come to our attention which causes us to believe that the financial statements are not true and fair...”). Normal procedures would be limited to analytical procedures and enquiries.

2.4.3 No level of assurance

Here, the professional accountant is giving no assurance at all for the engagement.

- (a) **Agreed-upon procedures (HKSRS 4400)** – the professional accountant and the entity determine the procedures to be performed and professional accountants will provide a report **of factual findings as** a result of undertaking those procedures.
- (b) **Compilation (HKSRS 4410 (Revised))** of financial or other information – professional accountants use their accounting expertise to collect, classify and summarise financial information, users of the compiled information will gain some benefits because professional accountants carry out their work with professional competence and due care.
- (c) **Preparation of tax returns.**
- (d) Management **consulting and advisory** services.

2.5 Accepting and continuing appointment



Topic highlights

Assurance engagements should only be accepted if the firm meets the requirements of the *Code of Ethics for Professional Accountants* and HKSQC 1 (Clarified).

The standard requires that practitioners ensure they comply with the *Code of Ethics for Professional Accountants* and the *Quality Control Standard* (HKSQC 1 (Clarified)) with regard to the assignment.

3 The purpose of external audit engagements



Topic highlights

An **external audit** is a type of **assurance engagement** that is carried out by a professional accountant to give an independent opinion on a set of financial statements.

3.1 Objective of external audit

3.1.1 HKSA 200 (Clarified)

HKSA 200.11

The objectives of external audit are laid out in HKSA 200 (Clarified) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.



Key term

The objectives of an **audit** are:

- (a) to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework: and
- (b) to report on the financial statements, and communicate as required by HKSAs, in accordance with the auditor's findings.

An audit of financial statements is an example of an assurance engagement.

3.1.2 Statutory audit

Professional accountants will provide a **reasonable level of assurance** to the “user”, after examination of a certain subject matter required by the entity. The most common example of an audit is where an independent professional accountant is engaged by the board of directors of an entity to examine the financial statements of the entity and issue an audit opinion to the shareholders (“the users”) of the entity in accordance with Hong Kong Companies Ordinance (Comp Ord) and the Hong Kong Auditing Standards. This is known as the **statutory audit**.

In Hong Kong, an audit of financial statements is **mandatory** for all entities incorporated under the **Hong Kong Companies Ordinance**. The professional accountant is required to state in his report as to whether the financial statements have been properly prepared in accordance with the provisions of the Companies Ordinance and give a true and fair view (S 141 Comp Ord).

HKSA 200 (Clarified) sets out the following principles for an audit. The firm must:

- (a) comply with ethical requirements
- (b) conduct the audit in accordance with HKSAs and determine the audit procedures
- (c) exercise professional judgment in planning and performing an audit of financial statements
- (d) obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level that is consistent with the objective
- (e) plan and perform the audit with an attitude of professional scepticism
- (f) not represent compliance with HKSAs unless it has really complied fully

The statutory audit can bring various advantages to the entity and shareholders. The key benefit to shareholders is the impartial view provided by the professional accountants. However, the entity also benefits from professional accountants reviewing the financial statements and system as part of the audit. Advantages might include recommendations being made in relation to accounting and control systems and the possibility that professional accountants might detect fraud and error. An auditor's report attached to the financial statements will add **credibility** to the financial statements and users will rely on the information they provide to make decisions. Audited financial statements will invite greater reliance to be placed on them by the users.

3.1.3 Audit process

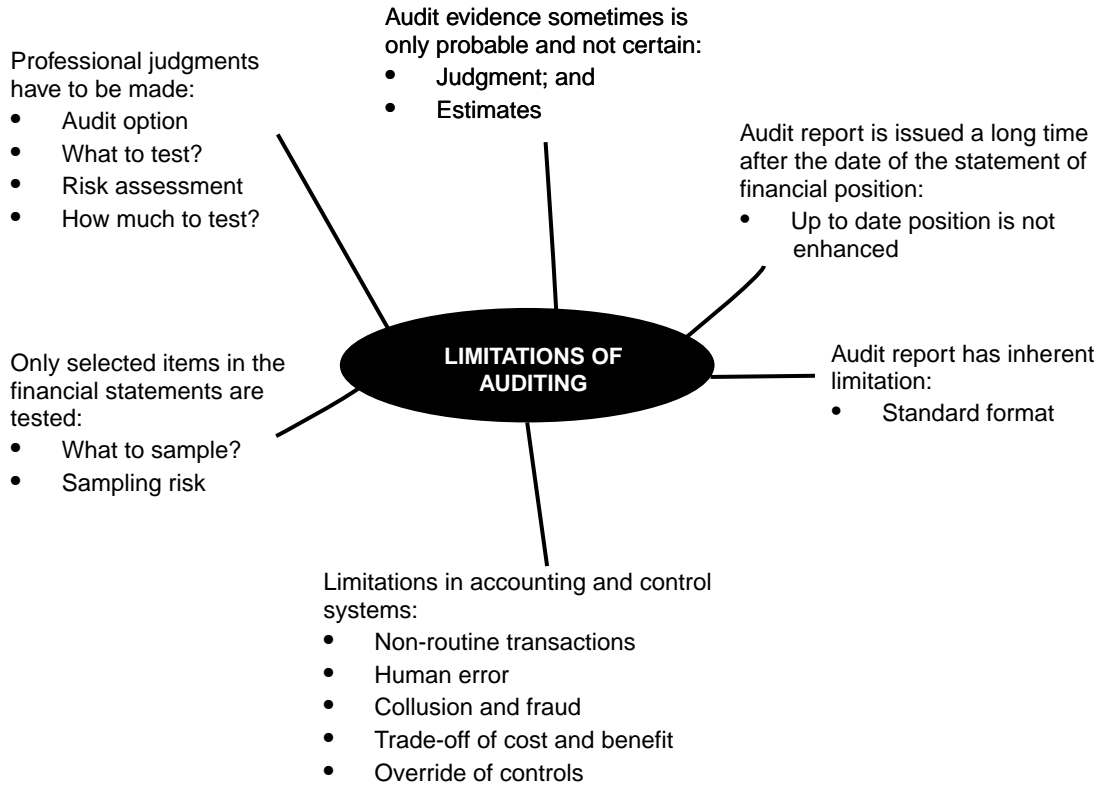
The following are the key steps of the audit process:

- Step 1** **Determine audit approach** as required by legislation and auditing standards.
- Step 2** **Ascertain the accounting system and internal controls** by fact finding and recording the system in operation.
- Step 3** Assess the accounting system and internal controls on their reliability and effectiveness in practice.
- Step 4** Test the accounting system and internal controls by performing tests of controls.
- Step 5** Test the financial statements by carrying out **substantive testing**.
- Step 6** **Review the financial statements** to determine the overall reliability of the financial statements.
- Step 7** **Express an opinion** in the form of an audit report.

3.1.4 Limitations of auditing

Audits only give **reasonable assurance** that the financial statements are free from material misstatements.

The diagram below illustrates the limitations of auditing:



3.1.5 True and fair

Where the professional accountant expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a **true and fair view**, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the firm's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a **true and fair view**.



Key terms

True: Information is factual and conforms with reality. In addition, the information conforms with required standards and law. The financial statements have been correctly extracted from the books and records.

Fair: Information is free from discrimination and bias and in compliance with expected standards and rules. The financial statements should reflect the commercial substance of the entity's underlying transactions.

The professional accountant's task is to decide whether the financial statements show a **true and fair view**. Professional accountants are not responsible for establishing whether the financial statements are correct in every particular detail. This is because it can take a great deal of time and trouble to check the accuracy of even a very small transaction and the resulting benefit may not justify the effort. Also financial accounting inevitably involves a degree of estimation which means that financial statements can never be completely precise.

3.2 Materiality

HKSA 200.6

Materiality is an expression of the **relative significance or importance** of a particular matter in the financial statements as a whole.

Any matter is material if its omission or misstatements would reasonably influence the economic decisions of users. Materiality has both quantitative and qualitative aspects. A misstatement can be quantitatively immaterial but qualitatively material eg omission of disclosure of major litigation.

The materiality level is determined at the **planning stage** to ensure any material misstatement in the financial statements can be discovered. The materiality level must be considered by the auditor in order to determine the nature, extent and timing of audit procedures and to evaluate the effect of misstatements discovered.

Some useful guidelines for measuring the materiality level are given below:

- 10% of pre-tax profits (normal criteria and applicable to most entities)
- 5% of gross profits (applicable to trading entities)
- 0.5–1% of revenue
- 0.5–1% of total assets (applicable to asset holding companies)

Other factors should be considered.

The assurance given by the auditor is governed by the fact that the auditor uses **judgment** in deciding what audit procedures to use and what conclusions to draw, and also by the **limitations** of every audit.

3.3 Professional scepticism



Key term

HKSA 200.15

Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Auditors should **never assume** the management is dishonest but should approach the audit with a **questioning mind** and a critical assessment of audit evidence, being alert to conditions which may indicate possible misstatement due to error or fraud. The professional accountant should adopt the following behaviours:

- Plan and perform an audit with **an attitude of professional scepticism**
- Be aware when audit evidence contradicts other audit evidence obtained
- **Raise awareness** to audit evidence that casts doubt on the reliability of documents or management representations
- Be cautious for any suspicious and unusual circumstances that may increase the risks of misstatement of financial statements
- Avoid using unrealistic assumptions in designing audit procedures or evaluating audit evidence
- Consider the reasonableness of responses
- Consider conditions that may indicate possible fraud

4 Reviews and other assurance engagements



Topic highlights

Assurance services include a range of assignments, from **external audits** to **review engagements**.

4.1 Review engagements

As discussed earlier in this chapter, an audit can be used to give assurance to a variety of stakeholders on many issues. However, an audit is an exercise designed to give a high level of assurance and involves a high degree of testing and it is therefore costly. In some cases, stakeholders may find that they receive **sufficient assurance** about an issue from a less detailed engagement, for example, a **review**. A review can provide a cost-efficient alternative to an audit where an audit is not required by law.



Key term

The objective of a **review engagement** is to obtain limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to the practitioner's attention that causes the practitioner to believe the financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

HKSRE
2400.14

The Preface to Hong Kong Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements (The Preface) requires that HKSREs are to be applied in the reviews of historical financial information. HKSRE 2400 (Revised) *Engagement to Review Historical Financial Statements* should be applied when a professional accountant, other than the auditor of an entity, undertakes an engagement to review historical financial statements. When an auditor of the reporting entity undertakes the engagement to review financial statements, the auditor should apply HKSRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.

The major outcome for recipients of a review engagement is that the **level of assurance** they gain from it is not as high as from an audit, although the procedures carried out in a review engagement are similar to an audit. We discuss review reports in more detail in Chapter 19.

4.2 Assurance engagements not dealing with historical financial information

It is HKSRE 3000 *Assurance Engagements other than Audits or Reviews of Historical Financial Information* that governs the assurance engagement other than audit and review of historical financial information. Examples of engagements under HKSRE 3000 are compliance engagements and performance audits. Further details will be covered in Chapter 19.

4.3 Investment circular reporting engagements

The Preface requires that HKSIRs are to be applied in investment circular reporting engagements.

Under HKSIR 300 *Accountants' Reports on Pro Forma Financial Information in Investment Circulars*, reporting accountants should include in the accountants' report a clear expression of opinion on the *pro forma* financial information. HKSIR 400 *Comfort Letters and Due Diligence Meetings on Financial and Non-financial Information*, has recently been revised. Further details will be covered in Chapter 19.

5 Non-assurance engagements



Topic highlights

No assurance is given for compilation or agreed-upon procedures engagements.

HKSRS 4400 *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information* applies to an agreed-upon procedures engagement where the professional accountant is to carry out procedures of an audit nature, which the professional accountant, the entity and any appropriate third parties have agreed and to report on **factual findings**.

HKSRS 4410 (Revised) *Compilation Engagements* governs a compilation engagement where it is for the professional accountant to use his accounting expertise to collect, classify and summarise financial information.

No assurance is expressed for the above engagements.



Self-test question 1

You are an audit senior of a CPA firm, Zeta & Partners (“Z&P”). Your manager has referred several cases to you to follow up. You find that the situations are quite different from the audits you normally perform and they are as follows:

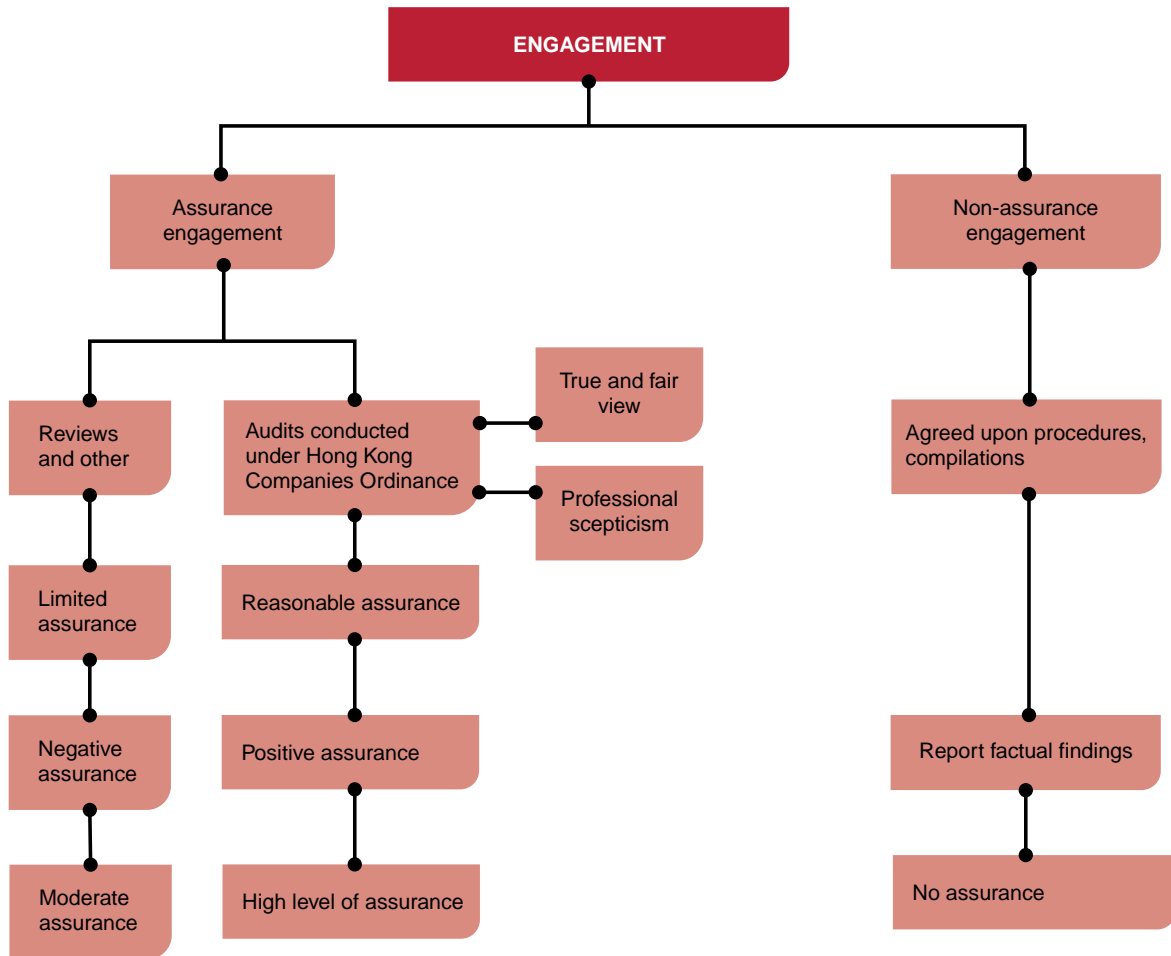
- (a) The Dutch holding company of A Limited (“A”) requires all of its subsidiaries to prepare special six-month interim financial statements. However, A has insufficient accounting resources to prepare the financial statements and requests Z&P to perform it for them.
- (b) B Limited (“B”) is listed on the Stock Exchange of Hong Kong. Members of the audit committee have resigned early in the financial year and have not been replaced yet. The remaining members are not comfortable to review the interim report on their own. The audit committee requests your firm to perform a review on the interim report.
- (c) The firm of the Japanese holding company of C Limited (“C”), which is a private company incorporated in Hong Kong, engaged in trading electronic components, send referral instructions to Z&P and request Z&P to perform a review on the interim consolidation package. In the referral instructions, the referring professional accountant requires Z&P to perform the review in accordance with HKSRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.
- (d) D Limited (“D”) is a retail company. In accordance with the tenancy agreement, D should pay the landlord a rent contingent on D's monthly sales revenue, evidenced by a sales certificate verified by D's professional accountants. Z&P is asked by D to verify and to issue such a sales certificate.
- (e) The New York Office of Z&P has sent referral instructions to Z&P to attend an inventory count on E Limited (“E”). E was incorporated in the United States and it has a liaison office and a warehouse in Hong Kong. Significant amount of inventory is kept in the warehouse. Therefore, it is a necessary procedure to perform the inventory count for obtaining audit evidence. The referral instructions have included detailed procedures for the inventory count. The fee will be allocated from the New York Office for this engagement.

Required

Explain to your audit manager the kind of services to be provided in each case. Where appropriate state the responsible party, the intended users, subject matter information, criteria of the engagements; and the relevant standards or other related guidance that should be followed when Z&P performs the engagement.

(The answer is at the end of the chapter)

Topic recap



Answer to self-test question

Answer

- (a) The preparation of interim financial statements is not an assurance engagement. Z&P should follow HKSQC 1 (Clarified) and HKSRS 4410 (Revised) *Compilation Engagements*. In addition, the firm should consider imposing safeguards on the staff being engaged to prepare the interim financial statements of the Company.
- (b) A review of interim financial report is an example of a review of financial statements and a form of limited/negative assurance engagement. The responsible party is the board of directors of B and the intended users are the shareholders. The subject matter information is the recognition, measurement, presentation and disclosure represented in the interim financial statements. The criteria is Hong Kong Accounting Standards. Z&P should follow HKSQC 1 (Clarified) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, *Hong Kong Framework for Assurance Engagements* and HKSRE 2400 (Revised) *Engagements to Review Historical Financial Statements*.
- (c) A review of an interim consolidation package is a limited assurance engagement. The responsible party is the board of directors of C and the intended user is the auditor of C. The subject matter information is the recognition, measurement, presentation and disclosure represented in interim consolidation package. The criterion is the relevant accounting standards, which may be International Accounting Standards or Hong Kong Accounting Standards. Z&P should follow HKSQC 1 (Clarified), *Hong Kong Framework for Assurance Engagements* and HKSRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.
- (d) The nature of the engagement depends on the details of the terms of engagement. Based on the information given, the engagement is likely to be an agreed-upon procedures engagement to provide factual findings on the amount of revenue during the period under consideration. An agreed-upon procedures engagement is not an assurance engagement. Z&P should follow HKSQC 1 (Clarified) and HKSRS 4400 *Engagements to Perform Agreed-Up On Procedures Regarding Financial Information*.
- (e) This is a referred audit work on attending an inventory count. The engagement should be performed in accordance with the instructions. Although this is part of the audit work to be performed for E by Z&P's office in New York, it is not an audit engagement for the purpose of Z&P's Hong Kong office. The work should be performed in accordance with the procedures as stated in the instructions, which are probably based on the US Auditing Standards or ISAs. Z&P should also follow HKSQC 1 (Clarified) and HKSRS 4400 *Engagements to Perform Agreed-Up On Procedures Regarding Financial Information*.

Exam practice



Noble Co

18 minutes

Your friend, a director of Noble Co, has written to you, in your capacity as an auditor, seeking clarification on several audit matters. These concern the appointment of auditors to Noble Co and the audit procedures they are likely to carry out. The following paragraphs have been extracted from his letter to you.

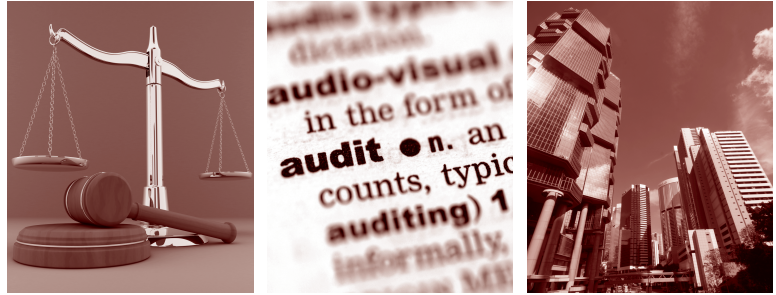
'To date Noble Co has not required a formal audit and it will not do so for the foreseeable future. However, the shareholders are now insisting that the annual financial statements must be audited by a firm of CPAs. I need confirmation of the primary objective of the audit of a limited liability company and also of how our shareholders and directors should benefit from an audit.'

Required

Write a letter to your friend which:

- (a) states the primary objective of the audit of a limited liability company; **(2 marks)**
- (b) outlines how the shareholders and directors of Noble Co should benefit from an audit of the company's financial statements by a firm of Certified Public Accountants. **(8 marks)**

(Total = 10 marks)



Part D

Assurance engagements

This Part discusses and explores different auditing techniques and standards employed in an assurance engagement. Students are expected to have a good understanding of them and appreciate the rationale or limitation associated. Further, students are expected to be able to apply what they have learnt in various practical cases.



chapter 6

Quality control

Topic list

- 1 Principles and purpose**
- 2 Quality control at a firm level**
 - 2.1 Objectives of HKSQC 1 (Clarified)
 - 2.2 Leadership responsibilities for quality within the firm
 - 2.3 Relevant ethical requirements
 - 2.4 Acceptance and continuance of client relationship and specific engagements
 - 2.5 Human resources
 - 2.6 Engagement performance
 - 2.7 Monitoring
- 3 Quality control on an individual audit**
 - 3.1 Leadership responsibilities
 - 3.2 Ethical requirements
 - 3.3 Acceptance/continuance of entity relationships and specific audit engagements
 - 3.4 Assignment of engagement teams
 - 3.5 Engagement performance
 - 3.6 Monitoring
 - 3.7 Quality control regulations

Learning focus

Issues relating to quality control are linked with both ethics and liability. In this chapter you will study the principles and purpose of quality control and how they can be applied at firm and individual audit level.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.06	Quality control considerations	3
2.06.01	Explain the principles and purposes of quality control of audit and other assurance engagements	
2.06.02	Identify the features of a system of quality control relevant to a specific firm	
2.06.03	Choose and explain quality control procedures that are relevant to a specific audit engagement	
2.06.04	Assess and explain whether an engagement has been performed in line with professional standards and whether reports issued are appropriate	

1 Principles and purpose



Topic highlights

Audit quality is not defined in law or through regulations, nor do auditing standards provide a simple definition.

Although not defined in law or through regulations, audit quality is necessary as the firm faces a variety of business risks in its operations, such as:

- disciplinary action against the firm from HKICPA
- litigation against the firm
- loss of entity due to competition, litigation or entity closure
- bad publicity

Although each stakeholder in the audit will give a different meaning to audit quality, at its heart it is about delivering an appropriate professional opinion supported by the necessary evidence and objective judgments. Note you studied the roles of different stakeholders in more detail in Chapter 1.

Many principles contribute to audit quality including good leadership, experienced judgment, technical competence, ethical values, appropriate entity relationships, proper working practices and effective quality control and monitoring review processes.

The standards on audit quality provide guidance to firms on how to put these principles into practice.

2 Quality control at a firm level



Topic highlights

In Hong Kong, it is the Hong Kong Standard on Quality Control (HKSQC 1 (Clarified)) that ensures that the firm and its staff comply with professional standards, and regulatory and legal requirements.

The fact that professional accountants follow accepted auditing standards (such as HKSA) provides a general quality control framework within which audits should be conducted. There are also specific quality control standards.

2.1 Objectives of HKSQC 1 (Clarified)

HKSQC1.11

Objectives

The objective of the firm is to establish and maintain 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.

The quality control standard ensures all firms (regardless of size) and their staff comply with professional standards, regulatory and legal requirements.

Quality control policies and procedures should be implemented to maintain audit work of a high standard. HKSQC 1 (Clarified) states that all quality control policies and procedures should be **documented** and should be properly **communicated** to all the partners and staff.

The engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned.

HKSQC 1 (Clarified) requires a firm to establish and maintain a system of quality control that includes policies and procedures that address the issues relating to the following areas:

- Leadership responsibilities for quality within the firm
- Relevant ethical requirements
- Acceptance and continuance of entity relationships and specific engagements
- Human resources
- Engagement performance (see also below, the requirements of HKSA 220 (Clarified))
- Monitoring

2.2 Leadership responsibilities for quality within the firm

HKSQC1.18-19

The standard goes into some detail as to how a firm should manage its internal strategy, processes and culture to firmly embed quality as an implicit principle in performing engagements. According to the standard the firm's chief executive (or equivalent) or, the firm's managing board of partners (or equivalent), must assume ultimate responsibility for the firm's system of quality control. It is the actions and messages disseminated from the most senior management of the firm that ensures specified norms of ethical behaviour, technical competence and quality service become those promulgated throughout the firm. However, while accountability must remain with the most senior management, responsibility for the design and implementation of formal systems of control may fall to individuals or groups of individuals specifically appointed to undertake these tasks.

Such individuals must have:

- sufficient and appropriate experience
- the ability to carry out the job
- the necessary authority to carry out the job

Within individual teams it is the engagement partner who takes on the role of leading the team and ensuring that the firm's prescribed quality standards and procedures are adhered to.

2.3 Relevant ethical requirements

HKSQC1.20

A firm is required to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. The required policies and procedures are discussed in Chapter 4 Section 2.9.

2.4 Acceptance and continuance of client relationship and specific engagements

HKSQC1.26-28

HKSQC 1 (Clarified) requires a firm to establish policies and procedures for the acceptance and continuance of client relationships and specific engagement. The detailed policies and procedures are discussed in Chapter 7.

2.5 Human resources

HKSQC1.29-31

The quest for quality will necessarily involve good HR practices. Competitive terms, good conditions and potential for future progression may ensure the firm can recruit and retain excellent staff but this is only one element in achieving excellence. The firm must also ensure staff are equipped with the technical expertise and other resources they need to fulfil their responsibilities, that they are motivated to carry out their professional duties to the highest ethical and technical

standards and that they are encouraged to further their own professional development in order to benefit, not only themselves, but their firm and their profession.

The standard states that the firm must provide itself with:

... “reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and applicable legal and regulatory requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances”.

These will cover the following issues:

- Recruitment
- Capabilities
- Career development
- Remuneration
- Performance evaluation
- Competence
- Promotion
- Forecasts of HR requirements

The firm is responsible for the ongoing excellence of its staff, through continuing professional development, education, work experience and coaching and mentoring schemes.

2.5.1 Assignment of engagement teams

The assignment of engagement teams is a very important determinant of quality. It is the role of the audit engagement partner to ensure the right team is brought together to fulfil a particular audit assignment and it is the audit engagement partner who holds responsibility for the overall audit quality of any engagements to which he is assigned.

There should be policies in place to ensure that:

- (a) key members of entity's staff and those charged with governance are aware of the identity of the audit engagement partner
- (b) the engagement partner has the appropriate capabilities, competence, authority and time to perform the role
- (c) the engagement partner is aware of the responsibilities of the role he has undertaken to perform
- (d) the engagement partner is aware of the any conflicts of interest or threats to independence which may bar a member of staff from being on the assurance team of an individual audit

The engagement partner should ensure that he assigns staff of sufficient capabilities, competence and time to individual assignments so that he will be able to issue an appropriate report.

2.6 Engagement performance

HKSQC1.32-
47

The firm must take steps to ensure that engagements are performed in accordance with professional standards and regulatory and legal requirements, and it is the responsibility of the audit engagement partner to ensure that they do. Often these requirements are compiled by a firm into a **manual of standard engagement procedures** which is issued to professional staff.

However, engagement performance goes beyond compliance and requires the following skills:

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

Many of these issues will be discussed in the context of an individual audit assignment (see below).

2.6.1 Consultation

The firm shall establish policies and procedures designed to provide it with reasonable assurance that:

- (a) appropriate consultation takes place on difficult or contentious matters
- (b) sufficient resources are available to enable appropriate consultation to take place
- (c) the nature, scope and conclusions of such consultations are documented
- (d) conclusions resulting from consultations are implemented

The firm may provide itself with reasonable assurance where necessary through external consultation with other firms, or the Institute. When there are differences of opinion on an engagement team, a report should not be issued until the disagreement has been resolved. The conclusions reached should be documented and implemented. Sometimes, the involvement of the quality control reviewer may be required. The firm should have procedures in place for dealing with and resolving differences of opinion.

2.6.2 Quality control reviews



Key terms

A **peer review** is a review of an audit file carried out by another partner in the assurance firm.

A **hot review** is a peer review carried out before the audit report is signed.

A **cold review** is a peer review carried out after the audit report is signed.

Quality reviews usually include an appraisal of working paper preparation, audit programmes, internal control, audit reports, staff functions, scheduling, supervision, client relations, and training. Whether a quality review will be undertaken for a specific engagement should be determined by criteria laid down in pre-determined policies established by the firm. Quality reviews are always undertaken on audits of the financial statements of listed entities and it is the responsibility of the engagement partner to find a suitable reviewer to undertake the work and ensure any contentious matters are resolved before the auditors' report is issued. The review will include an evaluation of any significant judgments made by the assurance team during the engagement and discussion of any matters which arise. The firm must also have procedures in place by which it can assess whether other engagements require review (ie those other than listed entities).

Each firm will have an established format for the quality control reviews it carries out: within this prescribed format standards will be laid down for the nature, timing and extent of the review, what qualifications and personal qualities need to be demonstrated by the reviewer and how the outcomes and processes of the review should be documented.

Quality control reviews

Nature, timing and extent	Usually the review includes discussion with the engagement partner, review of the financial statements or other subject matter information and the report. It will consider whether the final opinion is appropriate. There may also be a review of working papers relating to the most significant judgments made.
Eligibility	The reviewer must through their technical expertise and independence be qualified to undertake the review.
Documentation	Documentation must show that the firm's criteria for a review were met, that the review was finalised before the report was issued and include a representation that the reviewer is not aware of any unresolved issues.

Quality control reviews

All entities	<p>The review should include all the following:</p> <ul style="list-style-type: none"> • Discussion of significant matters with the engagement partner • Review of the financial statements or other subject matter information and the proposed report • Review of selected engagement documentation relating to significant judgments the engagement team made and the conclusions it reached • Evaluation of the conclusions reached in formulating the report and consideration of whether the proposed report is appropriate
Listed entities	<ul style="list-style-type: none"> • The engagement team's evaluation of the firm's independence in relation to the specific engagement • Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations • Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached

2.7 Monitoring

HKSQC1.48

The standard states that firms must have policies in place to ensure that their quality control procedures consistently meet the following criteria:

Quality control procedures are:

- **Relevant**, and
- **Adequate**

Quality control procedures:

- **Operate effectively**

Effectively the standard requires firms to continually evaluate and, where necessary, improve their quality controls to ensure that they consistently achieve high standards, reporting to senior management on the findings of quality monitoring.

There are two types of monitoring activity:

<i>Ongoing evaluation</i> of the system of quality control	An ongoing evaluation might include such questions as, "has it kept up to date with regulatory requirements"?
<i>Periodic inspection</i> of a sample of completed engagements	A period inspection cycle would usually take place over a period of say, three years, in which time, at least one engagement per engagement partner would be inspected.

The staff responsible for monitoring the control system are also required to evaluate the impact of any **deficiencies** identified. If the deficiencies are found to be single occurrences as a result of a specific set of circumstances corrective action might not be needed. Monitors are more concerned with **systematic or repetitive deficiencies that require corrective action to strengthen performance and the reliability of internal controls in the future**.

From time to time monitoring may highlight evidence that suggests an inappropriate opinion might have been issued in the auditors' report, and the firm may wish to seek legal advice. Where this is the case, the firm should follow the recommendations of their counsel.

The firm should also have policies and procedures in place in how to deal with complaints or allegations that the firm has failed to comply with professional standards including a process for investigating and defending these claims. Findings should be fed back into the quality control system to strengthen it in the future.

Responses to identified deficiencies:

- Remedial action with an individual
- Communication of findings with the training department
- Changes in the quality control policies and procedures
- Disciplinary action, if necessary



Self-test question 1

You established your own CPA practice six years ago which has now grown into a 15-staff firm. Your firm has been the auditor of an unlisted company, PQR Investment Limited (“PQR”), for six years. The shareholders of PQR have recently injected HK\$90 million of new capital into PQR with a view to acquiring companies in India, Thailand and Japan.

Required

Discuss what your CPA firm should consider before continuing to serve as the auditor of PQR in the forthcoming year. In particular, your discussion should be put in the context of PQR’s circumstances.

(13 marks)

HKICPA June 2011

(The answer is at the end of the chapter)

3 Quality control on an individual audit



Topic highlights

HKSA 220 (Clarified) requires firms to implement quality control procedures over individual audit engagements.

HKSA 220 (Clarified) *Quality Control for an Audit of Financial Statements* sets down requirements regarding quality control on individual audits. This HKSA applies the general principles of the HKSQC 1 (Clarified). The engagement team should implement quality control procedures that are applicable to the individual audit engagement under the direction of the audit engagement partner.

The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that the audit complies with professional standards and applicable legal and regulatory requirements and that the auditor’s report issued is appropriate in the circumstances.

3.1 Leadership responsibilities

HKSA 220.8

The engagement partner is required to set an example and instil a commitment in the team with regard to the importance of quality.

The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned.

Engagement partners should emphasise the importance of audit quality and the fact that quality is essential in performing audit engagements to the engagement team such as:

- performing work that complies with professional, regulatory and legal requirements;
- complying with the firm’s quality control policies and procedures;

- issuing auditor's reports that are appropriate in the circumstances; and
- the engagement team's ability to raise issues without fear of reprisals.

3.2 Ethical requirements

HKSA 220.9 -
11

In respect of independence requirements the standard refers to the HKICPA *Code of Ethics*, which you studied in Chapter 4.

The HKSA also contains some detailed guidance about independence in particular.

HKSA 220 (Clarified)

The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall:

- obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement;
- take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate actions.

The engagement partner should be on constant alert for evidence of non-compliance with the ethical Code and any threats to the independence of the assurance team. Inquiry and observation on ethical matters among the engagement partner and other members of the engagement team may occur as often as is deemed necessary throughout the audit engagement. If matters come to the engagement partner's attention through the firm's systems or otherwise that indicate that the independence of a member of the engagement team is in any way compromised, the partner should consult with other senior members of the firm to devise an appropriate course of action, which may include removal of the individual from the team, appropriate disclosures to the entity or other safeguards which you studied in detail in Chapter 3.

3.3 Acceptance/continuance of entity relationships and specific audit engagements

HKSA
220.12-13

The partner is required to ensure that the requirements of HKSQC 1 (Clarified) in respect of accepting and continuing with audits are adhered to. If information emerges during the audit that may have caused the partner to decline it he should disclose this to the firm and immediate action may need to be taken.

If the engagement partner obtains information that indicate the firm shall decline the audit engagement, the engagement partner is required to communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary actions.

HKSA 220.14

3.4 Assignment of engagement teams

As discussed in the previous section, the assignment of appropriate teams is also the responsibility of the audit engagement partner. He must ensure that the team is sufficiently qualified and experienced as a unit to perform the particular engagement to which he has been assigned.

The engagement partner should also be satisfied that the engagement team collectively has the appropriate capabilities, competence and time available to it to perform the audit engagement in accordance with professional standards and regulatory and legal requirements. The overall objective is to enable an auditor's report that is appropriate in the circumstances to be issued.

3.5 Engagement performance

HKSA 220.15

The engagement partner is required to take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements; and the auditor's report being appropriate in the circumstances.

3.5.1 Direction

It is the engagement partner who gives overall direction to the audit. Other auditing standards list among his responsibilities the requirement to hold a meeting with the engagement team to discuss the audit scope and plan, in particular the associated risks. This standard suggests that direction includes reminding or informing members of the engagement team of:

- their responsibilities (including objectivity of mind and professional scepticism)
- objectives of the work to be performed
- the nature of the entity's business
- risk-related issues
- problems that may arise
- the detailed approach to the performance of the engagement

3.5.2 Supervision

The audit is supervised overall by the engagement partner, but at an operational level supervision is given by senior team members to more junior members. More experienced members of the team will also review the work carried out by more junior members at appropriate stages during the engagement. The reviews should include the following:

- (a) Monitoring the progress of the audit engagement
- (b) Reviewing the capabilities and competence of individual team members, including whether they have sufficient time and understanding to carry out their work competently and within the audit plan
- (c) Addressing significant issues arising during the audit engagement and modifying the audit plan if necessary
- (d) Identifying matters to be referred to more experienced engagement team members

3.5.3 Review

Review includes consideration of whether the following requirements have been met:

- (a) The work has been performed in accordance with professional standards and regulatory and legal requirements
- (b) Significant matters have been raised for further consideration
- (c) Appropriate discussions have taken place, any conclusions have been documented and implemented
- (d) There is a need to revise the nature, timing and extent of work performed
- (e) The work performed supports the conclusions reached and is appropriately documented
- (f) The evidence obtained is sufficient and appropriate to support the auditor's report
- (g) The objectives of the engagement procedures have been achieved

Before the audit report is issued, the engagement partner must be sure that sufficient and appropriate audit evidence has been obtained to support the audit opinion.

3.5.4 Consultation

The engagement partner should be satisfied that members of the engagement team have undertaken **appropriate consultation** on any contentious matter. This may be within the

engagement team, or between the engagement team and others at the appropriate level either within or outside the firm. The technical partner or a panel of partners may be involved.

The engagement partner should be involved in these consultations and be satisfied that the matters are resolved satisfactorily and any actions are documented and implemented.

From time to time differences of opinion may arise between the engagement partner and the team, or between the engagement partner and the quality control reviewer. The firm should have an established procedure for resolution of differences of opinion.

3.5.5 Quality control review

As discussed earlier, the audit engagement partner is responsible for **appointing** a reviewer, if the criteria for a review is met. He is then responsible for discussing significant matters arising with the reviewer and for ensuring the audit report is not issued until the quality control review has been completed and any contentious matters resolved.

A quality control review should include:

- (a) an evaluation of the **significant judgments** made by the engagement team
- (b) an evaluation of the **conclusions** reached in formulating the audit report

HKSA 220 (Clarified) requires the **evaluation** to include:

- (a) discussion of significant matters with the engagement partner;
- (b) review the proposed auditor's report and the financial statements;
- (c) review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and
- (d) evaluation of the conclusion reached for composing the auditor's report.

For **listed entities' audits**, an engagement quality control reviewer is required to consider the following factors:

- (a) Independence – the engagement team's evaluation of the firm's independence in relation to the specific audit
- (b) Consultation – appropriate consultation taken place on matters to resolve differences of opinion or other difficult or contentious matters
- (c) Documentation – whether audit documentation selected for review reflects the work performed in relation to the significant judgments and support the conclusions reached

An engagement quality control reviewer shall evaluate the significant judgments made by the engagement team for engagement quality control review of a listed entity:

- (a) HKSA 315 (Revised) – significant risks identified during the engagement;
- (b) HKSA 330 (Clarified) – responses to those risks;
- (c) HKSA 240 (Clarified) – engagement team's assessment and responses to risks of fraud;
- (d) Judgments made for materiality and significant risks;
- (e) The significance and disposition of corrected and uncorrected misstatements identified during the audits;
- (f) Matters communicated to management and those charged with governance and other parties such as regulatory bodies; and
- (g) The appropriateness of the auditor's report to be issued.

3.5.6 Differences of opinion

HKSA 220 (Clarified) requires the engagement team to follow the firm's policies and procedures for dealing with and resolving any such differences of opinion.

3.6 Monitoring

HKSA 220.23

The audit engagement partner is required to take account of the results of monitoring the firm's quality control systems and consider whether they have any impact on the specific audit to which he is assigned. The engagement partner considers:

- whether deficiencies noted in that information may affect the audit engagement; and
- whether the measures the firm took to rectify the situation are sufficient in the context of that audit.



Self-test question 2

You are an audit senior working for the firm Chan & Chan. You are currently carrying out the audit of Kleaner Co ("Kleaner"), a manufacturer of waste paper bins. You are unhappy with Kleaner's inventory valuation policy and have raised the issue several times with the audit manager who has dealt with the entity for a number of years and does not see what you are making a fuss about. He has refused to meet you on site to discuss these issues.

The former engagement partner to Kleaner retired two months ago. As the audit manager had dealt with Kleaner for so many years, the other partners have decided to leave the audit of Kleaner in his capable hands.

Required

What are the quality control issues arising in the situation above?

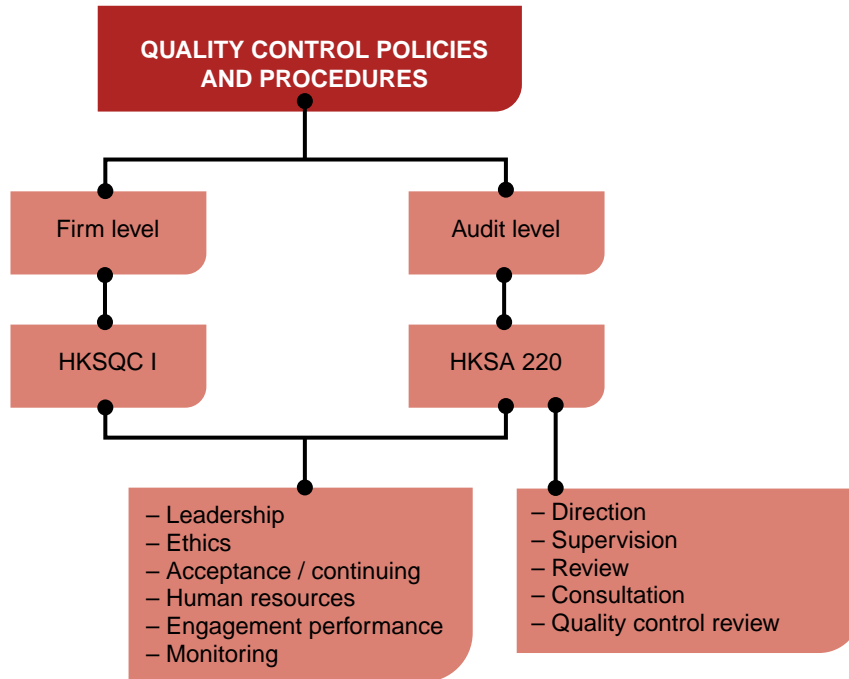
(The answer is at the end of the chapter)

3.7 Quality control regulations

The regulations for quality control on audits are the same for all audit firms regardless of their size and structure. However, it is logical to see that their impact on large and small firms will be different.

A large firm may establish international quality control procedures on a global scale and certainly at least on a national or regional basis. They are also likely to have sufficient resources in-house to carry out its full range of control functions. Small, single-partner firms may need to make extensive use of external experts in order to fulfil all of its obligations.

Topic recap



Answers to self-test questions

Answer 1

HKSQC 1 (Clarified) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* requires your firm to consider and document certain matters before continuing to serve as PQR's auditor.

Those matters include:

- the integrity of PQR (ie its shareholders, directors and management);
- whether your firm is competent to do the work; and
- whether your firm meets ethical requirements in relation to the work.

There is no clear evidence compromising the integrity of PQR even though you may question the source of the new funding into PQR.

As your firm has been the auditor of PQR for six years, competency is not likely to be questioned.

However, the increase of PQR's scale of activities and its forthcoming overseas acquisitions may challenge your firm's competency.

Challenges may include the industries, locations and sizes of those companies being acquired as well as the forms of investments (eg equity, debt or quasi-equity) and the availability of properly audited financial statements.

Being associated with PQR (as its auditor) for six years may indicate a close relationship. However, it is not entirely clear if the extent of relationship may pose any familiarity threat to your firm.

You should be satisfied that appropriate procedures regarding the continuance of client relationship and audit engagement with PQR have been followed, and that conclusions reached in this regard are appropriate and have been documented.

Answer 2

Several quality control issues are raised in the scenario:

Engagement partner

An engagement **partner** is usually appointed to each audit engagement undertaken by the firm, to take responsibility for the engagement on behalf of the firm. Assigning the audit to the experienced audit manager is not sufficient.

The lack of an audit engagement partner also means that several of the requirements of HKSA 220 (Clarified) about ensuring that arrangements in relation to independence and directing, supervising and reviewing the audit are not in place.

Conflicting views

In this scenario the audit manager and the audit senior have conflicting views about the valuation of inventory. This does not appear to have been handled well, with the audit manager refusing to discuss the issue with the audit senior.

HKSA 220 (Clarified) requires that the audit engagement partner takes responsibility for settling disputes in accordance with the firm's policy in respect of resolution of disputes as required by HKSQC 1 (Clarified). In this case, the lack of an engagement partner may have contributed to this failure to resolve the disputes. In any event, at best, the failure to resolve the dispute is a breach of the firm's policy under HKSQC 1 (Clarified). At worst, it indicates that the firm does not have a suitable policy for resolving such disputes as required by HKSQC 1 (Clarified).

Exam practice



Independence and familiarity

14 minutes

(excluding case reading time)

You are the audit manager of a Hong Kong CPA firm and are currently planning the audit of ABC Industrial Limited ("ABC") for the year ended 31 December 20X4. ABC is a company incorporated in Hong Kong and is engaged in the manufacture of a wide range of Chinese herbal health products. Sales of ABC products, which consist of sixty-nine product lines, are mainly made to major chain stores and drug retailers in Hong Kong. You and the engagement partner have been serving ABC since its listing on the Hong Kong Stock Exchange six years ago.

After discussion with ABC's management and a review of last year's audit file, the following information has come to your attention:

- (1) Goods are manufactured centrally at ABC's factory in GuanXi, China, and are then stored in the Company's warehouses either in GuanXi or in Hong Kong.
- (2) The inventory is stored in three warehouses in Hong Kong, and two warehouses in GuanXi. All warehouses are owned by the Company. In order to minimise operating costs, the Company occasionally leases out its unused warehouse spaces to its customers to temporarily store the products which it has already sold to them.
- (3) ABC uses a perpetual inventory system to keep its inventory. All warehouses are closed at the reporting date to allow a full physical inventory taking. However, production in the GuanXi factory will not stop during the physical inventory taking.
- (4) ABC uses standard costing to value its inventory. At the year-end, the inventory value will be adjusted as and when necessary to absorb cost variances in order to approximate actual production cost in accordance with relevant accounting standards. From previous experience, adjustments rarely deviate more than 3% from the standard cost.
- (5) Year-end inventory accounts for approximately 23% of ABC's total assets, and is expected to be disclosed in ABC's financial statements as follows:

	\$'000
Raw materials	8,800
Work in progress	13,290
Finished goods	20,730
	<u>42,820</u>

- (6) Raw materials largely comprise bulk inventories of various Chinese herbs, which are stored separately in storage containers of different sizes either at the factory or the two warehouses nearby. ABC keeps more than 500 different herbs. Many of these raw materials are used in more than one product and some are expensive Chinese herbs. Most have long use-by-dates provided that they are properly stored. The identification of Chinese herbs requires expert knowledge since many different herbs with significantly different costs and effects have a similar appearance. The costs of different classes of the herb could vary materially even for the same Chinese herb.
- (7) Work in progress largely comprises mixed or semi-processed herbs, which are stored in several locations throughout the factory, either in large sealed vats awaiting processing or in sealed mixing containers attached to various machines in the factory. Therefore, it is not possible for the staff of ABC to directly observe the conditions of the work in progress. Production is fully automated within a sealed environment once raw materials are input. As required by the licensing terms, ABC employs several qualified Chinese herb experts to ensure compliance with quality standards.

Business Assurance

- (8) A typical product of ABC has a two-year use-by-date from the date of production.
- (9) Inventory levels of one product line, Series X, have increased steadily throughout the year under review. ABC's management assured you that since this is a new line, it would take time for the market to get used to it.
- (10) The recent launch of a new product, Z, resulted in poorer than expected sales. Consequently, ABC has excess inventory in finished goods, amounting to HK\$3,800,000. The use-by-date of this product is eleven months after the reporting date.

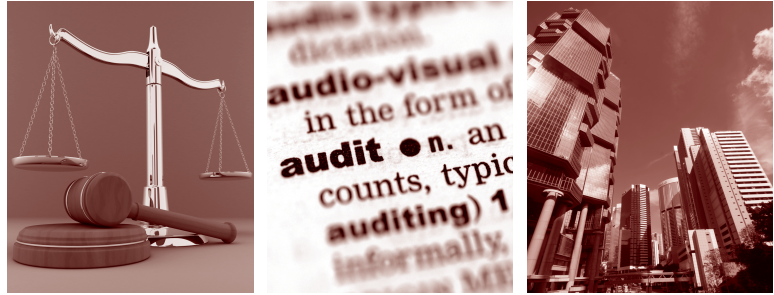
Required

In accordance with HKSQC 1 (Clarified) and HKSA 220 (Clarified):

- (a) Explain the engagement partner's responsibility regarding compliance with the independence requirements; and **(5 marks)**
- (b) Determine whether the familiarity threat has been properly addressed in this audit engagement. **(3 marks)**

(Total = 8 marks)

HKICPA May 2005 (amended)



chapter 7

Changes in auditor appointment

Topic list

- | | |
|--|---|
| <p>1 Reasons for change of auditors</p> <p>1.1 Why do entities change their auditors?</p> <p>2 Appointment of auditors</p> <p>2.1 Appointment under Hong Kong Companies Ordinance</p> <p>2.2 Procedures to change auditors under Hong Kong Companies Ordinance</p> <p>2.3 Auditor's rights and duties</p> <p>2.4 Outgoing auditors</p> <p>2.5 Professional clearance</p> <p>3 Client acceptance procedures</p> <p>3.1 Procedures before accepting nomination</p> <p>3.2 Procedures after accepting nomination</p> <p>3.3 Procedures for the transfer of books, papers and information following a new appointment</p> <p>3.4 Issues relating to the acceptance decision</p> <p>3.5 Client screening</p> | <p>4 Engagement letters</p> <p>4.1 Purpose of sending engagement letter</p> <p>4.2 When to send an engagement letter</p> <p>4.3 Contents of an engagement letter</p> <p>5 Books and documents</p> <p>5.1 Audit documentation</p> <p>5.2 Ownership</p> <p>5.3 The right of lien</p> <p>5.4 Third party rights to information</p> <p>5.5 Entity's rights to information</p> <p>5.6 Assembly of the final audit file</p> <p>5.7 Changes to audit documentation in exceptional circumstances after the date of the auditor's report</p> <p>5.8 Transfers of books and documents on a change of appointment decision</p> |
|--|---|

Learning focus

It is very important for professional accountants to understand the rules with regard to the appointment of auditors and changes in auditors. The contents of an engagement letter can be vitally important if there is subsequently a dispute between auditor and client as to the nature of the engagement. Consequently, it should never be regarded as routine correspondence.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.03	Client and engagement acceptance procedures	3
2.03.01	Explain the reasons why entities change their auditors / professional accountants	
2.03.02	Explain the requirements relating to the appointment of auditors under the Hong Kong Companies Ordinance	
2.03.03	Explain the procedure for a change of auditors	
2.03.04	Explain the rights of the auditors in the process of a change of auditors	
2.03.05	Explain the professional clearance procedures	
2.03.06	Explain the matters to be considered and the procedures that an audit firm/professional accountant should carry out before accepting a specified new client/engagement including:	
2.03.06.01	Client acceptance	
2.03.06.02	Engagement acceptance	
2.03.06.03	Agreement of the terms of engagement	
2.03.07	Identify the issues relating to the agreement of the scope and terms of an engagement with a client	
2.03.08	Explain the procedures for the transfer of books, papers and information following a new appointment	

1 Reasons for change of auditors



Topic highlights

Common reasons behind entities changing their auditor include audit fee, auditor not seeking re-election and the size of entities.

1.1 Why do entities change their auditors?

Entities change their auditors for a variety of reasons. The reason may be because the entity is seeking to access new or better quality services; or because they disagree with an opinion issued in a report. The entity may disagree with conservative accounting treatments that in management's opinion do not present the entity's results fairly, or there may be another reason for a deterioration in the relationship of trust. Equally, an auditor may decline to perform audit services for a client for ethical reasons, such as unpaid fees or a conflict of interest. Although not required to disclose the reasons for the change, investors may be interested to know why an entity has made a change as it sometimes acts as a signal of financial difficulties or poor governance.

The list below summarises some of the main reasons an entity may change its auditors:

- (a) **Fee reduction** – a company may wish to reduce its audit costs and may, for example choose to switch from a “Big Four” firm to a mid-tier firm in order to obtain a lower fee
- (b) **Compliance** with the *Code of Ethics* – undue dependence on an entity, for example
- (c) **Competitive market**. Lowballing and significant low fees (see Chapter 3) can induce clients to change their auditors in order to make a saving
- (d) **Dispute with entity on accounting policies**, although new accounting standards have gone some way to redress this by giving less scope for judgment
- (e) **Breakdown in relationship** due to audit rotation, intimidation, threatened litigation and so on
- (f) **Doubt cast on the integrity of management**, the auditor declines the appointment
- (g) Entity's request for provision of other **services** or better quality services which the current firm is **unable to provide**
- (h) **Retiring auditor** not to be nominated for re-appointment

2 Appointment of auditors



Topic highlights

The Hong Kong Companies Ordinance sets out the legal requirements associated with the appointment and removal of auditors.

2.1 Appointment under Hong Kong Companies Ordinance

At the incorporation of a new company the directors should appoint an auditor within three months and the appointed auditor shall hold office until the conclusion of the first Annual General Meeting (AGM) (s.131(3) Hong Kong Companies Ordinance). If the directors fail to do so, the auditors may be appointed by the company at the first general meeting.

Under s. 131(1) of the Hong Kong Companies Ordinance, every company must appoint an auditor at its Annual General Meeting (AGM) to hold office from the conclusion of that meeting until the conclusion of the next AGM. By s. 131(2) of the Hong Kong Companies Ordinance, if an auditor is not appointed or reappointed at the AGM, any member of the company may submit an application to the court for the appointment of auditor.

According to s. 131(5) of the Hong Kong Companies Ordinance, the directors may appoint the auditor to fill a casual vacancy. This arises on disqualification, removal or resignation of the auditor before the end of term. The auditor being appointed by the company must be qualified and must not have been previously disqualified from acting as an auditor. The auditor must also hold a practising licence issued under the Professional Accountants Ordinance.

2.2 Procedures to change auditors under Hong Kong Companies Ordinance

Under s. 132 (1) of the Hong Kong Companies Ordinance, a **special notice** is required for a resolution at an AGM to:

- appoint as auditors a person other than a retiring auditor
- fill a casual vacancy in the office of auditor
- reappoint auditors when a retiring auditor has been appointed to fill a casual vacancy
- removal of an auditor before expiration of his office (special notice and ordinary resolution)

Special notice should be sent to the affected auditor (incoming or outgoing).

2.3 Auditor's rights and duties



Topic highlights

The Hong Kong Companies Ordinance gives auditors both rights and duties. This allows auditors to have sufficient power to carry out an independent and effective audit.

The rights and duties of auditors are set out in the Hong Kong Companies Ordinance, to ensure that the auditors have sufficient power to carry out an effective audit.

2.3.1 Statutory duties

The auditors are required to report on every statement of financial position and statement of profit or loss and other comprehensive income laid before the entity in a general meeting.

The auditors must consider the following:

- (a) Whether the financial statements have been prepared in accordance with the relevant legislation
- (b) Whether the statement of financial position shows a true and fair view of or presents fairly the entity's affairs at the end of the period and the statement of profit or loss and other comprehensive income and cash flow statement show a true and fair view of the results for the period
- (c) Whether adequate accounting records have been kept
- (d) Whether the financial statements are in agreement with the accounting records and returns
- (e) Whether the information in the directors' report is consistent with the financial statements
- (f) Whether disclosure of directors' benefits has been made in accordance with the Hong Kong Companies Ordinance

2.3.2 Statutory rights

The auditors must have certain rights to enable them to carry out their duties effectively and they are as follows:

Right to access information

According to s. 141(5) of the Hong Kong Companies Ordinance, auditors have a right to access at all times the books and financial statements and vouchers of the client and to obtain explanations from its officers. A holding company has a right to obtain information and explanations from a Hong Kong subsidiary. For a subsidiary outside Hong Kong the Hong Kong holding company may reasonably require information and explanation for the purpose of a Hong Kong audit.

Right to attend general meetings

Under s. 141(7) of the Hong Kong Companies Ordinance, auditors are entitled to attend any general meeting of the client and receive notice of any general meeting which any member of the company is entitled to receive. They are also entitled to be heard at any general meeting on any part of the business which concerns them as auditors.

Right to remuneration

An auditor who is appointed under the Hong Kong Companies Ordinance has the right to remuneration or fees. In accordance with s. 131(8) of the Hong Kong Companies Ordinance in general, an auditor's remuneration is fixed by the company in the general meeting. However, where the auditor is appointed by the directors or by the court, then the fees will be fixed by them.

2.3.3 Enhancement of auditor's rights

The new Hong Kong Companies Ordinance ("the new CO") enhances the rights of auditors. Pursuant to s. 412 of the new CO, auditors may require information and explanation for the performance of their duties from a **wider range of persons**, including persons holding or accountable for any accounting records of the company or a Hong Kong incorporated subsidiary of the company.

It also empowers auditors to require the company to obtain information and explanation for the performance of their duties from **persons holding or accountable for the accounting records** of a non-Hong Kong incorporated subsidiary.

A person who fails to provide the required information or explanation to auditors commits an offence and is liable to a fine not exceeding \$25,000 and, in the case of a continuing offence, a daily fine not exceeding \$700.

Section 410 of the new CO gives an auditor qualified privilege for statements made in the course of performing duties as auditor of the company. In particular, in the absence of malice, an auditor is not liable for defamation in respect of any cessation statement or statement of circumstances connected with his or her cessation of office.

Under s. 425(1) of the new CO, the auditor's duty to make a statement of circumstances connected with the cessation of office is extended from cases of resignation of auditors to the situations where the auditor is removed from office and where a retiring auditor is not reappointed.

The new CO is expected to commence operation in 2014.

2.4 Outgoing auditors

2.4.1 Retiring auditor or auditor proposed to be removed

According to the Hong Kong Companies Ordinance, a retiring auditor or an auditor proposed to be removed have the right to:

- make written representations to the entity
- request the written representations to be sent to all members of entity

- require the written representations to be **read in a general meeting**
- attend any meetings covering matters which concern them as auditors
- receive all notices relating to such meetings concerned with the auditors

2.4.2 Removal of auditor

The removed auditor can attend general meetings concerned with the removed auditor's term of office and can receive all notices which a member is entitled to receive on matters concerning them as auditors.

2.4.3 Resignation of auditor

Auditors can resign by **depositing a notice in writing** at the registered office of the entity. The registration is not effective unless it contains either a properly signed statement that there are no circumstances connected with the resignation or a statement of any such circumstances as aforesaid; and it is signed.

When the notice is deposited at the company's registered office, the auditor shall within 14 days send a copy of the notice to the Registrar; and to every person entitled to be sent.

When the auditor resigns, the auditor must tender to the company:

- a statement of circumstances, or
- a statement that there are no circumstances connected with his resignation

On receipt of the above statements, the company or any person related, may within 14 days of the receipt by the company of a notice containing statement, apply to the court for an order.

Additionally, the auditor can request the directors to call an extraordinary general meeting to consider the statement for the purpose of receiving and considering explanation connected to his resignation.

Directors are required within 21 days to proceed duly to convene a meeting for a day not more than 28 days after the date on which the notice of convening the meeting.

2.5 Professional clearance

Section 440 of the Code of Ethics – Changes in Professional Appointment

A proposed nominee should conduct professional clearance procedures before accepting the nomination.

With the permission of the prospective client, the proposed nominee should write to the last appointed auditor and ask if there are any unusual circumstances of which the proposed nominee should be aware before accepting the nomination. The proposed nominee should not accept the engagement if the prospective client fails to deal with the change of auditor in accordance with Hong Kong Companies Ordinance or fails to give permission for communication with the last appointed auditor.

The last appointed auditor should advise the proposed nominee immediately if there is any **professional or other reason** of which the proposed nominee should be aware and in addition, the circumstances surrounding the proposed change and disclose fully all information needed by the proposed nominee to enable him to make decision in respect of accepting the nomination.

If the last appointed auditors have suspicions of **unlawful acts** by directors which have not yet been proved, they should inform the nominee auditor of any matters that ought to be investigated.

If the replacement of the last appointed auditor is prompted by **disagreement** over matters such as the truth and fairness of the entity's financial statements or the selection of accounting policies or methods used in auditing, the proposed nominee should obtain the full views of the last appointed auditors. In addition, the proposed nominee should discuss with the entity the areas of disagreement. The proposed nominee should be prepared to accept nomination only if he is satisfied it is ethically appropriate to do so.

This is an example of an initial communication.

Dear Sirs

We have been nominated to act as auditors of Limited.

In order to assist us in determining whether to accept such nomination, we should be grateful if you would advise if there are any circumstances surrounding the proposed change of which we should be aware.

Yours faithfully,

2.5.1 Changing auditors of a listed entity

Section 441 of the Code of Ethics – Change of Auditors of a Listed Issuer of the Stock Exchange of Hong Kong

If there are any disagreements between auditors and the client, the issues should be raised with the audit committee so that the committee may help to resolve the issues with management and to complete the audit.

The last appointed auditor should write a letter of resignation/termination to the audit committee and the board of directors in the event of the resignation or refusing re-appointment, which lists any **disagreements or unresolved issues** relating to the audit.

The proposed nominee should request a copy of **the letter of resignation/termination** and any correspondence from the listed entity. If the entity refuses to send the proposed nominee the letter of resignation/termination, the proposed nominee can only decline to accept nomination.

The last appointed auditor should remind the listed entity of its obligation under the Listing Rules and should ensure the letter of resignation/termination has been brought to the attention of the shareholders. Any disputes should be reported to the audit committee.



Self-test question 1

Engineering Materials Manufacturing Company Limited is a company listed on the Hong Kong Stock Exchange. Engineering Materials Manufacturing Company and its subsidiaries (“EMM”), are principally engaged in the manufacture and trading of engineering materials, including steel, iron, aluminium, cement, timber and asphalt. EMM’s customers are mainly construction and engineering companies in Mainland China, Hong Kong and other Asian countries. As at 31 December 20X6, over 90% of EMM’s assets were located in Mainland China.

In view of the booming economy in Mainland China, EMM embarked on an expansion plan two years ago to double the group’s revenue within five years. EMM plan to implement this strategy through acquisition of other manufacturers as well as setting up new plant in strategic locations in the Mainland. In the last two years, an increasing trend in revenue and receivables has been noted.

On 21 December 20X6, EMM succeeded in issuing debentures of US\$130,000,000 at an interest rate of 9.5% per annum. The debentures are listed on an overseas exchange. The proceeds received were used partly to repay bank loans when they were due, while the remaining cash was kept in banks in Mainland China.

EMM’s previous auditor, XYZ & Co, was re-appointed in April 20X6 after it reported on EMM’s financial statements for the year ended 31 December 20X5. However, XYZ & Co resigned in November 20X6.

XYZ & Co had proposed a fee which doubled the fee it charged EMM in the last year but EMM did not accept the increment. According to EMM, they wanted to change auditors periodically to ensure independence. According to XYZ & Co, the firm is prepared to rotate the engagement partner in accordance with quality control standards.

The directors of EMM approached ABC & Co in January 20X7 and proposed to appoint them as the auditor of EMM’s financial statements for the year ended 31 December 20X6.

Required

Determine XYZ & Co's ethical obligations in relation to the change in auditors.

HKICPA May 2007 (amended)

(The answer is at the end of the chapter)

3 Client acceptance procedures



Topic highlights

HKSQC 1 (Clarified) sets out what a firm must consider and document in relation to accepting or continuing an engagement which is the integrity of the entity, whether the firm is competent to do the work and whether the firm meets ethical requirements in relation to the work.

HKSQC1.26

HKSQC 1 (Clarified)

The firm shall establish policies and procedures for the acceptance and continuance of entity relationships and specific engagements designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where it:

- (a) has considered the **integrity of the entity** and does not have information that would lead it to conclude that the entity lacks integrity
- (b) is **competent** to perform the engagement and has the capabilities, time and resources to do so, and
- (c) can comply with relevant **ethical** requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new entity, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing entity. Where issues have been identified, and the firm decides to accept or continue the entity relationship or a specific engagement, it should document how the issues were resolved.

3.1 Procedures before accepting nomination

The following procedures should be carried out before accepting nomination:

- (a) Ensure that there are **no ethical issues** which are a **barrier** to accepting nomination ie changes in auditor's independence
- (b) Ensure that the auditor is **professionally qualified** to act and that there are no legal or technical barriers
- (c) Ensure that the existing **resources** are **adequate** in terms of staff, expertise and time
- (d) Obtain **references for the directors** if they are not known personally to the audit firm
- (e) **Consult the last appointed auditors** to ensure that there are not any reasons behind the vacancy which the new auditors ought to know. This is also a courtesy to the last appointed auditors
- (f) Obtain and **review available financial statements**
- (g) **Make inquiries of third parties** such as those charged with governance, or internal auditors etc

- (h) **Consider unusual high business risk** – any complex transactions, aggressive deals or attitude towards matters such as aggressive interpretation of accounting standards or the internal control environment
- (i) **Consider management's** attitude towards compliance with regulatory or contractual obligations
- (j) Consider any indication of **money laundering** or other criminal activities committed by management

For an existing entity, the firm should consider its ability to continue the engagement and if there is any significant **change in management/financial condition** which affects the firm's ability to continue the relationship. The firm should reassess the integrity of management if there is a change in management.

3.2 Procedures after accepting nomination

As previously set out the firm should ensure that the **last appointed auditors' removal or resignation** has been **properly conducted** in accordance with the Hong Kong Companies Ordinance and that the **new auditors' appointment is valid**. The new auditors should obtain a copy of the resolution passed at the general meeting appointing them as the entity's auditors. An engagement letter should be submitted to the entity for finalising the engagement terms, which we shall look at later.

3.3 Procedures for the transfer of books, papers and information following a new appointment

Section 440 Code of Ethics

The last appointed auditor shall provide promptly the requested information to the newly appointed auditors. The information shall be relevant to the entity's affairs and no charge shall be made unless there is good reason to the contrary.

The working papers belong to the last appointed auditor who is under no legal obligation to pass his working papers to the newly appointed auditors for review. However, the last appointed auditor has an ethical obligation to respond to the newly appointed auditor's specific inquiries and shall pass the working papers relating to matters of continuing accounting significance in respect of those specific areas.

3.4 Issues relating to the acceptance decision

HKSQC1.28,
A19
HKSA220.12-
13

HKSQC 1 (Clarified) gives a list of matters that the auditors might consider in relation to the acceptance decision.

Matters to consider

Integrity of an entity

- The identity and business reputation of the entity's principal owners, key management, related parties and those charged with governance
- Nature of the entity's operations, including its business practices
- Information concerning the attitude of the entity's principal owners, key management, those charged with governance towards matters such as aggressive interpretation of accounting standards/internal control environment
- Whether the entity is aggressively concerned with keeping the firm's fees as low as possible
- Indications of an inappropriate limitation in the scope of work
- Indications that the entity might be involved in money laundering or other criminal activities
- The reasons for the proposed appointment of the firm and non-reappointment of the last appointed auditors
- Identity and business reputation of related parties

Competence of the firm

- Do firm personnel have knowledge of relevant industries/subject matters?
- Do firm personnel have experience with relevant regulatory or reporting requirements, or the ability to gain the necessary skills and knowledge effectively?
- Does the firm have sufficient personnel with the necessary capabilities and competence?
- Are experts available, if needed?
- Will staff need further training to do the work?
- Are individuals meeting the criteria and eligibility requirements to perform the engagement quality control review available where applicable?
- Is the firm able to complete the engagement within the reporting deadline?

In addition, the firm needs to consider whether acceptance would create any conflicts of interest.

HKSQC1 (Clarified)

The firm shall establish policies and procedures on continuing an engagement and the client relationship, addressing the circumstances where the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures shall include consideration of:

- (a) the professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities, and
- (b) the possibility of withdrawing from the engagement or from both the engagement and the entity relationship.

Such procedures might include discussions with the entity's management and those charged with governance, and, if required, discussions with the appropriate regulatory authority.

There are requirements for the engagement partner in relation to specific engagements as follows:

HKSA 220 (Clarified)

The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

If the engagement partner obtains information that would have caused the firm to decline the audit engagement if that information had been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action.

**Self-test question 2**

- (a) You are a partner in Talent and Co (“Talent”), a firm of Certified Public Accountants. You have just successfully tendered for the audit of Lunch Co (“Lunch”), a chain of sandwich shops. The tender opportunity was received cold, that is, the entity and its officers are not known to the firm. The entity has just been incorporated and has not previously had an audit. You are about ready to accept nomination.

Required

Explain the procedures should you carry out prior to accepting nomination.

- (b) In the course of your acceptance procedures you received a reference from a business contact of yours concerning one of the five directors of Lunch, Mr Lau. It stated that your business contact had done some personal tax work for Mr Lau ten years previously, when he had found Mr Lau to be difficult to keep in contact with, slow to provide information and he had suspected Mr Lau of being economical with the truth when it came to his tax affairs. As a result of this distrust, he had ceased to carry out work for him.

Required

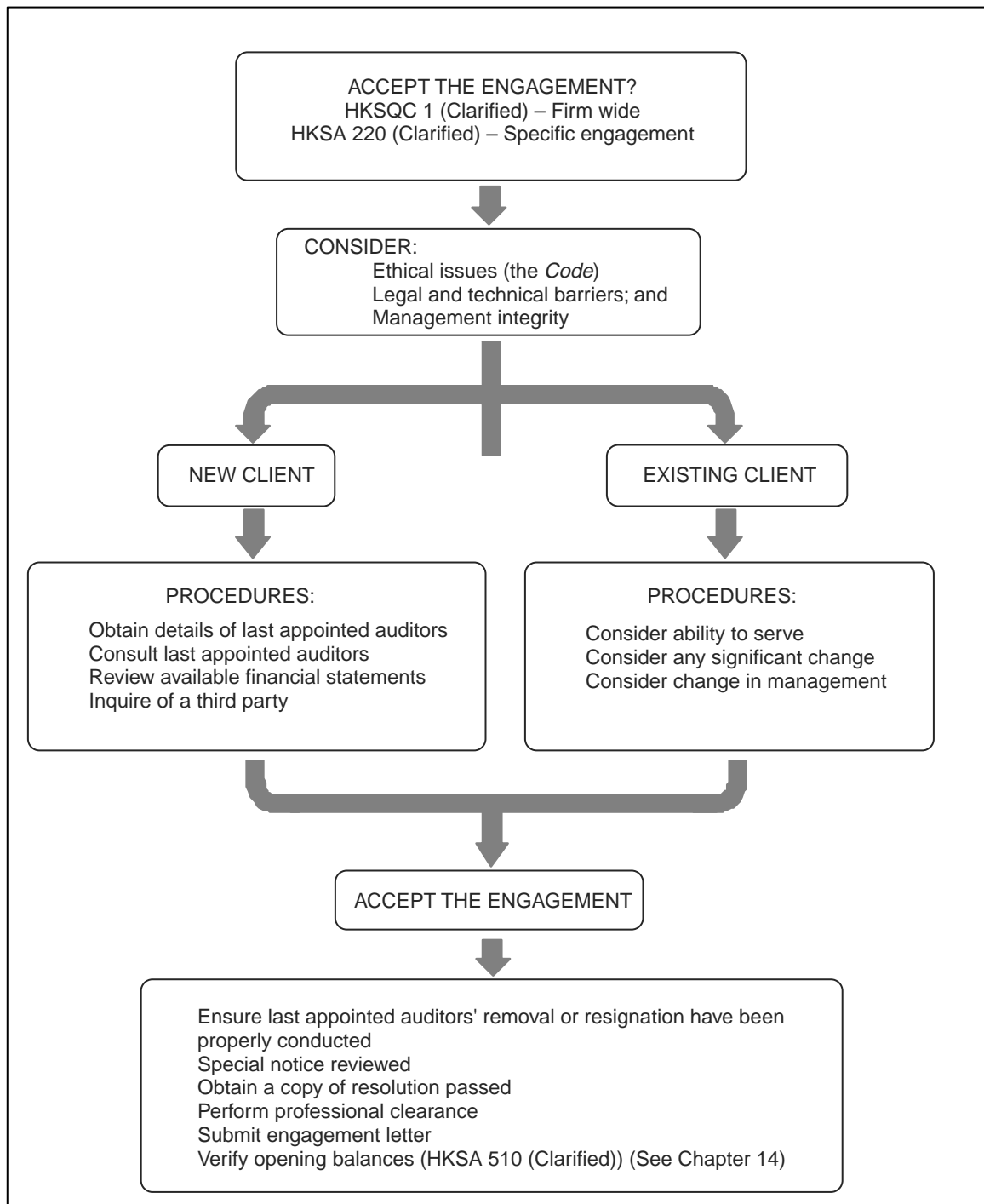
Comment on the effect this reference would have on accepting nomination.

(The answer is at the end of the chapter)

3.5 Client screening

Many firms would use a **checklist** to screen potential clients. Entities can be divided into categories based on the level of risk associated with their business practices: as low risk for entities who demonstrate a high level of effective internal control and strong performance or high risk for entities who have a history of poor performance, lack of finance, weak internal controls, integrity issues or unclear related party transactions. For high risk entities firms may consider employing specialists in response to diagnosed risks to act as an independent reviewer.

The following flow chart summarises the acceptance procedures for new and existing clients:



4 Engagement letters



Topic highlights

Certain issues must be agreed in writing when an audit is accepted.

4.1 Purpose of sending engagement letter

Before any professional work is undertaken, an engagement letter should be issued.

Under HKSA 210 (Clarified) *Agreeing the Terms of Audit Engagement*, before the start of any professional work, the auditor and its entity should agree, in writing, the scope and nature of the work to be undertaken. This is through the engagement letter. The purposes of the engagement letter are:

- to help avoiding misunderstanding with respect to the engagement
- to confirm auditor's acceptance of the engagement
- to confirm the objective and scope of the audit
- to clearly state the auditor's duties and responsibilities of the entity
- to state the form of report it is going to issue
- to prevent misunderstandings between the auditor and the entity
- to confirm the fee basis and any verbal arrangements in writing

HKSA 210.9

4.2 When to send an engagement letter

The engagement letter is issued or revised in the following situations:

- For new clients, the engagement letter should be sent before any professional work has been started.
- For recurring audits, whenever there is a significant change in circumstances, a revised engagement letter should be sent. The engagement partner should consider whether there is a need for a new engagement letter annually.
- For group companies, the auditor will send an engagement letter relating to the group as a whole and identifies the components for which they are appointed as auditors.

HKSA
210.10,
Appendix 1

4.3 Contents of an engagement letter

The engagement letter should state the auditor's and the client's statutory duties and responsibilities.

The following is a list of the sections that will or might appear in an engagement letter:

- Objective of the financial statement audit
- Directors' responsibilities – keeping proper accounting records, and making them available to the auditors
- Auditor's responsibilities – to form an opinion on the entity's financial statements as to whether they show a true and fair view and comply with the Hong Kong Companies Ordinance
- Scope of auditor's work – ie applicable legislation, regulations and auditing standards, review accounting system, collection of audit evidence, and tests of internal controls
- Form of reports for the engagement
- Stating an unavoidable risk that some material misstatements may still be undiscovered due to inherent limitations of an audit

- (g) Expectation of receiving a letter of representation from the management
- (h) Any additional work required from auditor – bookkeeping, taxation or other services
- (i) Irregularities and fraud – primary responsibility is on directors
- (j) Fees and basis of charge
- (k) The effective date of the engagement letter
- (l) Letter of acknowledgement from the board

HKSA 210 (Clarified)

A template of the audit engagement letter is set out below:

To the directors of _____:

Objective of services

- 1.1 You have requested that we audit the financial statements of [ABC Company Limited]. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

Responsibilities of directors

- 2.1 Our audit will be conducted on the basis that you acknowledge and understand that you have responsibility:
- a. To maintain proper books of account of the company;
 - b. For the preparation of financial statements which give a true and fair view in accordance with [insert applicable financial reporting framework] [Hong Kong Financial Reporting Standards][Hong Kong Financial Reporting Standard for Private Entities] and have been prepared in accordance with the Companies Ordinance;
 - c. For such internal control as you determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
 - d. To provide us with:
 - (i) Access to all information of which you are aware that is relevant to the preparation of the financial statements such as company's books of account and all other relevant records and documentation, including minutes of all management and shareholders' meetings and other matters;
 - (ii) Additional information that we may request from you for the purpose of the audit; and
 - (iii) Unrestricted access to persons within the company from whom we determine it necessary to obtain audit evidence.

Responsibilities of the auditor

- 3.1 We have a statutory responsibility to report to the members whether in our opinion the financial statements give a true and fair view and whether they have been properly prepared in accordance with the Companies Ordinance. In arriving at our opinion, we are required to consider the following matters, and to report on any in respect of which we are not satisfied:
- a. whether proper books of account have been kept by the company and proper returns adequate for our audit have been received from branches not visited by us;
 - b. whether the company's balance sheet and profit and loss account are in agreement with the books of account and returns; and
 - c. whether we have obtained all the information and explanations which we consider necessary for the purposes of our audit.

In addition, there are certain other matters which, according to the circumstances, may need to be dealt with in our report. For example, where the financial statements do not give details of directors' remuneration or of loans to officers, the Companies Ordinance requires us to disclose such matters in our report.

- 3.2 We have a professional responsibility to report if the financial statements do not comply in any material respect with [insert applicable financial reporting framework] [Hong Kong Financial Reporting Standards][Hong Kong Financial Reporting Standard for Private Entities], unless in our opinion the noncompliance is justified in the circumstances. In determining whether or not the departure is justified, we consider:
- a. whether the departure is required in order for the financial statements to give a true and fair view; and
 - b. whether adequate disclosure has been made concerning the departure.

Scope of audit

- 4.1 Our audit will be conducted in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by you, as well as evaluating the overall presentation of the financial statements.
- 4.2 Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with HKSAAs.
- 4.3 In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit. Any such report may not be provided to third parties without our prior written consent. Such consent will be granted only on the basis that such reports are not prepared with the interests of anyone other than the company in mind and that we accept no duty or responsibility to any other party as concerns the reports.
- 4.4 As part of our audit procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the audit on matters having a material effect on the financial statements. In connection with representations and the supply of information to us generally, we draw your attention to section 134 of the Companies Ordinance.
- 4.5 In order to assist us with the examination of your financial statements, we shall request sight of all documents or statements, including the chairman's statement, operating and financial review and the directors' report, which are due to be issued with the financial statements. We are also entitled to attend all general meetings of the company and to receive notice of all such meetings.

- 4.6 The responsibility for safeguarding the assets of the company and for the prevention and detection of fraud, error and non-compliance with law or regulations rests with you. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the financial statements or books of account (including those resulting from fraud, error or non-compliance with law or regulations), but our examination should not be relied upon to disclose all such material misstatements or frauds, errors or instances of non-compliance as may exist.
- 4.7 (Where appropriate - Note) We shall not be treated as having notice, for the purposes of our audit responsibilities, of information provided to members of our firm other than those engaged on the audit (for example, information provided in connection with accounting, taxation and other services).
- 4.8 Once we have issued our report we have no further direct responsibility in relation to the financial statements for that period. However, we expect that you will inform us of any material event occurring between the date of our report and that of the Annual General Meeting which may affect the financial statements.

(Consolidated financial statements

5. As the auditor of the holding company we are required to report, in similar terms to those outlined in paragraph 3.1 above, on the group's consolidated financial statements, which comprise the financial statements of the holding company and its subsidiaries. In order to express an opinion on group's consolidated financial statements which include the financial information of subsidiaries, joint ventures or associated companies of which we are not the auditor, it will be necessary for us to communicate directly with the other auditor(s) concerned to satisfy ourselves that:
- a. so far as is practicable, there is uniformity within the group in the application of accounting policies;
 - b. the consolidated financial statements give the information required by the Companies Ordinance, applicable accounting standards and any other legislation or non-statutory requirements affecting the presentation of financial statements; and
 - c. all material aspects of the consolidated financial statements have been subjected to an audit examination, the nature and extent of which is adequate and reasonable, in our view, for the purpose of forming an opinion on the group's consolidated financial statements.)*

Reporting

- 6.1 [Insert appropriate reference to the expected form and content of the auditor's report.]
- 6.2 The form and content of our report may need to be amended in the light of our audit findings.

(Other services

7. You have requested that we provide other services in respect of The terms under which we provide these other services are dealt with in a separate letter.)*

Fees

8. Our fees are computed on the basis of the time spent on your affairs by the partners and our staff and on the levels of skill and responsibility involved plus out-of-pocket expenses. Unless otherwise agreed, our fees will be billed at appropriate intervals during the course of the audit and will be due on presentation.

Agreement of terms

- 9.1 Once it has been agreed, this letter will remain effective, from one audit appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

(9.2 Since the terms of our engagement as auditors of the subsidiaries listed in the attached appendix are the same, we will not send separate letters to the board of directors of each subsidiary. We would therefore be grateful if you would forward copies of this letter to the boards of directors of each such subsidiary and confirm that these boards have also agreed and confirmed their acceptance of this letter.)*

Yours faithfully,

ABC & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

Date

We agree to the terms of this letter.

(Signed)

..... Director, for and on behalf of the board of

Date

* Delete where not applicable.

Note

When accounting, taxation or other services are undertaken on behalf of an audit client, information may be provided to members of the audit firm other than those engaged on the audit. In such cases, it may be appropriate for the audit engagement letter to include this or a similar paragraph to indicate that the auditor is not to be treated as having notice, for the purposes of the auditor's responsibilities, of such information, to make it clear that a company would not be absolved from informing the auditor directly of a material matter.

5 Books and documents



Topic highlights

Audit working papers belong to the auditor. Sometimes, the terms “working papers” or “work papers” are used.

HKSA 230.5,
7-11

5.1 Audit documentation

Audit documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and the conclusions the auditor reached.

In accordance with HKSA 230 (Clarified) *Audit Documentation*, the auditor prepares, on a timely basis, audit documentation that provides:

- a sufficient and appropriate record of the basis for the auditor's report
- evidence that the audit was performed in accordance with HKSAs and applicable legal and regulatory requirements.

HKSA 230 (Clarified) requires that the auditor prepares audit documentation on a timely basis in order to enhance the quality of the audit. This is to allow sufficient time to review and evaluate the audit evidence obtained and conclusions reached before the auditor's report is finalised.

5.1.1 Nature, form, content and extent of audit procedures performed

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor having no previous connection with the audit, to understand. It should include:

- the nature, extent and timing of the audit procedures performed to comply with HKSAs and applicable legal and regulatory requirements
- the results of the audit procedures performed and the audit evidence obtained
- significant matters arising during the audit ie significant risks or difficulties in applying audit procedures

5.2 Ownership

Audit working papers are owned by the auditor. In the event of auditors taking over an audit from another firm, they are **not entitled** to take over all the audit files that that firm has put together on the entity.

The HKSA states that in order to ensure continuity of an entity's affairs, the last appointed auditors must provide the new auditors with all the **reasonable carry-over information** they request, and they should do this **promptly**. The last appointed auditor should ensure that he transfers all the books and documents belonging to the entity to the new auditors without delay. He is only allowed to keep entity's books where he is entitled to exercise a **lien**.

5.3 The right of lien



Key term

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.

If the last appointed auditor is still owed fees by the client, he may have a right under common law to exercise a lien over some of the client's books. General liens over property can rarely be established. However, it may be possible for an auditor to have a particular lien when a client owes a debt specifically in respect of that property.

A right of particular lien will only exist where the following conditions are fulfilled:

- The documents must be the property of the entity itself (not a closely related third party)
- The documents must have come into the professional accountant's possession by proper means
- The work must have been done and a fee note rendered in respect of it
- The fee must relate to the retained documents

5.4 Third party rights to information

As discussed in Chapter 4, the auditor owes a duty of confidentiality to the client. This means that documents containing information about the client should not be given to third parties unless:

- the client agrees to the disclosure before it is made
- disclosure is required by statute or court order
- disclosure is otherwise in accordance with the *Code of Ethics*

5.5 Entity's rights to information

Audit working papers are the property of the auditor and as such, the **client has no right of access to them**. The firm may allow the client access to the working papers if it so chooses.

However, the position is more complicated when the work undertaken is something other than audit. For example, if the firm puts together the **financial statements** on behalf of the client, those financial statements will belong to the client.

With tax work, documents created in carrying out **tax compliance work** will belong to the client.

HKSA 230.14

5.6 Assembly of the final audit file

The auditor should assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. After the assembly, the auditor should not delete or discard audit documentation of any nature before the end of its retention period, which is no shorter than five years from the date of the auditor's report.

There is further discussion on audit documentation in Chapter 8.

HKSA 230.16

5.7 Changes to audit documentation in exceptional circumstances after the date of the auditor's report

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

- the circumstances encountered
- the new or additional audit procedures performed
- when and by who the resulting changes to audit documentation were made and reviewed
- the specific reasons for making them

5.8 Transfer of books and documents on a change of appointment

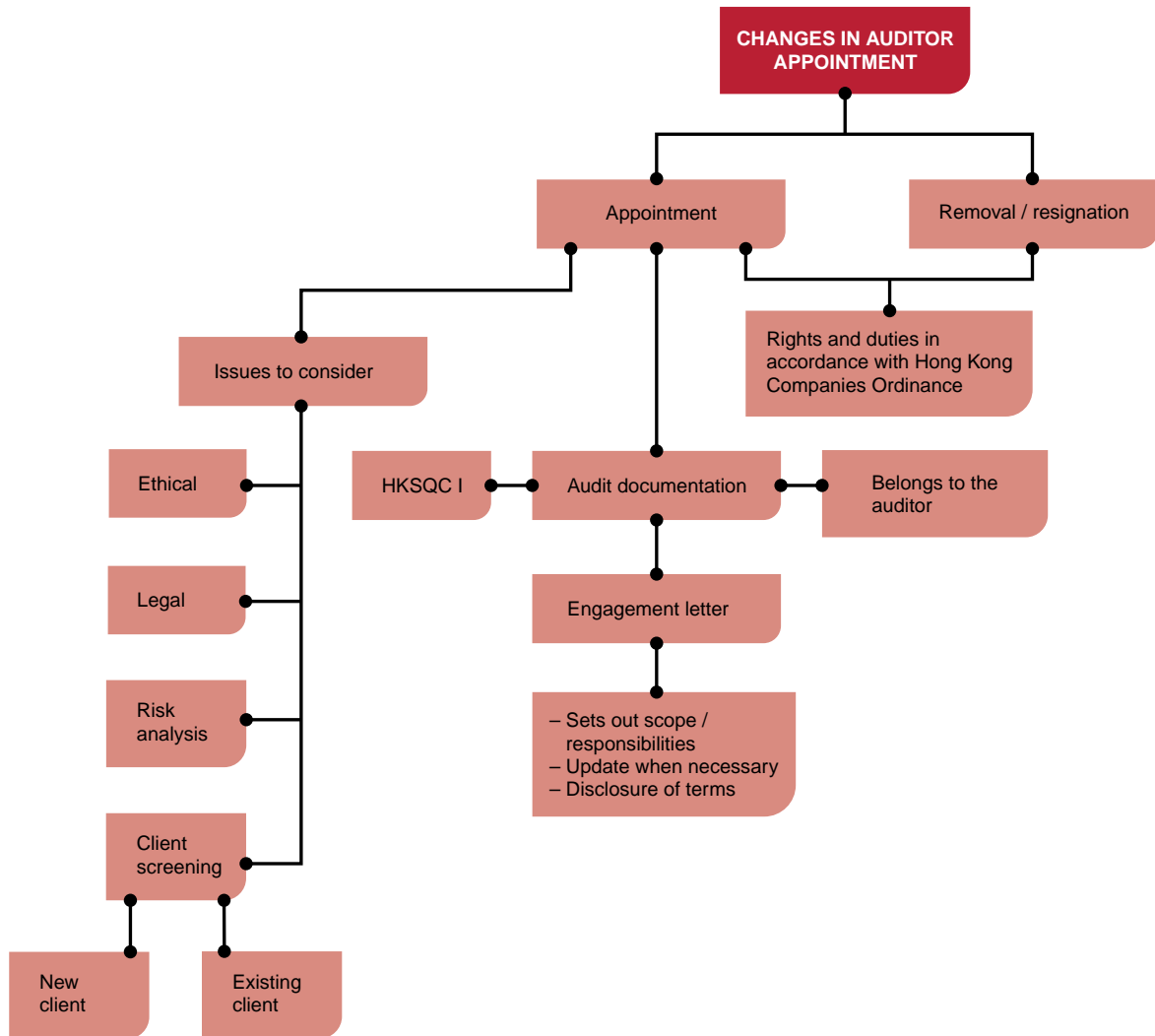
5.8.1 Section 440 Code of Ethics

Section 440 of the *Code of Ethics* states the following with regards to the transfer of books and documents following a change of appointment:

The last appointed auditor shall provide promptly the requested information to the newly appointed auditors. The information shall be relevant to the entity's affairs and no charge shall be made unless there is good reason to the contrary.

The working papers belong to the last appointed auditor who is under no legal obligation to pass his working papers to the newly appointed auditors for review. However, the last appointed auditor has an ethical obligation to respond to the newly appointed auditor's specific inquiries and shall pass the working papers relating to matters of continuing accounting significance in respect of those specific areas.

Topic recap



Answers to self-test questions

Answer 1

XYZ & Co's ethical obligations in relation to the change in auditors of EMM are governed by the *Code of Ethics for Professional Accountants* ("the Code"). In particular, XYZ & Co should comply with the requirements of Section 441 "*Change of Auditors of a Listed Issuer of the Stock Exchange of Hong Kong*" since EMM is listed on the Hong Kong Stock Exchange.

According to Section 441 of the Code, XYZ & Co should prepare a Letter of Resignation addressed to the audit committee and the board of directors of EMM.

The Letter of Resignation should disclose all the occurrences that, in the opinion of XYZ & Co, affect the relationship between EMM and XYZ & Co. Such occurrences include, but are not limited to, "disagreements" and/or "unresolved issues".

According to the Code, ABC & Co should make a request in writing to XYZ & Co to ask if there are any unusual circumstances surrounding the proposed change which ABC & Co should be aware of, so that ABC & Co may determine whether it should accept the nomination.

On receipt of the written request, XYZ & Co should act expeditiously. If there are no professional or other reasons why ABC & Co should not accept the nomination, XYZ & Co should reply accordingly without delay.

If XYZ & Co considers it appropriate to discuss EMM's affairs with ABC & Co, XYZ & Co should request EMM's permission to do so freely. If permission is not granted, XYZ & Co should report that fact to ABC & Co (who should not accept the nomination).

If, in the opinion of XYZ & Co, there are matters of which ABC & Co should be made aware, XYZ & Co should inform ABC & Co of those factors of which, in the opinion of XYZ & Co, ABC & Co should be aware. XYZ & Co may, for example, inform ABC & Co that the reasons advanced by EMM for the change are not in accordance with the facts.

For example, XYZ & Co may inform ABC & Co of the fact that it proposed a rotation of the engagement partner as an appropriate safeguard against the familiarity threat to independence, and that EMM did not accept the increase in audit fee.

If EMM are Hong Kong incorporated listed issuers, s 140A(2) of the Companies Ordinance requires an auditor who resigns from office before the expiry of his term, if the resignation is to be effective, to include in his resignation a statement of any circumstances connected with his resignation which he considers ought to be brought to the notice of members or creditors of the company, or a statement that there are no such circumstances.

Answer 2

- (a) The following procedures should be carried out:
- (i) Ensure that I and my engagement team are professionally qualified to act and consider whether there are ethical barriers to my accepting nomination.
 - (ii) Review the firm's overall work programme to ensure that there are sufficient resources to enable my firm to carry out the audit.
 - (iii) Obtain references about the directors as they are not known personally by me or anyone else in my firm.
- (b) The auditor must use his professional judgment when considering the responses he gets to references concerning new clients. The guidance cannot legislate for all situations so it does not. In the circumstance given above there is no correct answer therefore, in practice an auditor would have to make a justified decision which he would then document.

Matters to be considered

The reference raises three issues for the auditor considering accepting nomination.

- (i) The issue that the director has been difficult to maintain a relationship with in the past
- (ii) The issue that the director was slow to provide information in the past
- (iii) The suspicion of a lack of integrity in relation to his tax affairs

The auditor must consider these in the light of several factors:

- (i) The length of time that has passed since the events
- (ii) What references which refer to the interim time say
- (iii) The difference between accepting a role of auditing an entity and personal tax work
- (iv) The director's role in the entity and therefore the audit
- (v) The amount of control exercised by the director
 - Relationships with other directors
 - Influence

At this stage he should not be considering how highly he values the opinion of the referee. That should have been considered before he sent the reference. At this stage he should only be considering the implications of the reference for his current decision.

Auditing an entity is different from auditing personal affairs in terms of obtaining information and contacting personnel. In this case, the key issue is the question over the integrity of the director.

As we do not have information about interim references and details of the business arrangements it is difficult to give a definite answer to this issue. However, Mr. Lau is likely to only have limited control over decisions of the entity being one of five directors, which might lead to the auditor deciding that the reference was insufficient to prevent him accepting nomination. If Mr. Lau were the Chief Financial Officer, the auditor would be more inclined not to take the nomination.

Exam practice



ZZZ Holding Limited

32 minutes

Initially established approximately fifteen years ago, ZZZ Holdings Limited (“ZZZ”) is a listed company on the Main Board of the Hong Kong Stock Exchange. ZZZ’s primary business is the manufacture and sale of a wide range of decorative and entertainment lighting. ZZZ has over 6,000 employees and four factories in Mainland China.

Ms Apple Au is the founder (and the Chief Executive Officer) of ZZZ and has always placed a great emphasis on innovation, quality control and quality assurance. ZZZ has more than 50 research engineers and develops over 100 new models each year. ZZZ also has a broad portfolio of patented products and is constantly developing more innovative products with more advanced technology. In May 20X8, ZZZ’s previous auditor (Red and Blue) retired and declined to stand for re-appointment after reporting on the financial statements for the year ended 31 December 20X7 in ZZZ’s annual general meeting.

In August 20X8, Ms Au invited Ms Orange Or’s firm (Gold and Silver) to be the new auditor. Ms Au had met Ms Or (an audit partner of Gold and Silver) through her secondary school alumni dinner in 20X7.

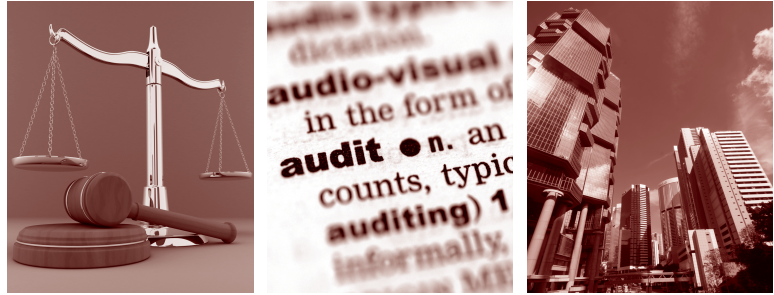
Gold and Silver has recently been engaged in three initial public offering exercises and is very short of manpower. Ms Or is in the process of assessing this prospective engagement. ZZZ’s Accounting Manager has provided Ms Or with the audited financial statements for the year ended 31 December 20X7 and the unaudited management accounts for the eight months ended 31 August 20X8.

Required

- (a) Briefly explain the procedures (other than the independence consideration) Gold and Silver should carry out before the acceptance of Ms Au’s invitation. **(6 marks)**
- (b) Following on from part (a) above, explain how Ms Or should assess the integrity of Ms Au and the key management of ZZZ. **(6 marks)**
- (c) Explain the ethical obligations of Gold and Silver regarding the change in auditors. **(6 marks)**

(Total = 18 marks)

HKICPA September 2008



chapter 8

Planning, materiality and risk assessment

Topic list

- | | |
|---|--|
| <p>1 Audit planning</p> <p>1.1 The importance of planning</p> <p>1.2 The audit strategy and the audit plan</p> <p>1.3 Agreeing the terms of audit engagement</p> | <p>4 Risk</p> <p>4.1 Audit risk</p> <p>4.2 Business risk</p> |
| <p>2 Understanding the entity and its environment</p> <p>2.1 Why understanding is important</p> <p>2.2 Impact of the internal audit function</p> | <p>5 Risk assessment</p> <p>5.1 Identifying and assessing the risks of material misstatement</p> <p>5.2 Risks of material misstatement at financial statement level or assertion level</p> <p>5.3 Significant risks</p> <p>5.4 Automation risk</p> |
| <p>3 Materiality</p> <p>3.1 Applying materiality in the context of financial reporting and auditing</p> <p>3.2 Purposes for setting materiality levels in the context of an audit of financial statements</p> <p>3.3 Materiality for the financial statements as a whole</p> <p>3.4 Materiality for the particular classes of transactions, account balances or disclosures</p> <p>3.5 Performance materiality</p> | <p>6 Overall responses to assessed risk of material misstatement</p> <p>6.1 Overall responses to risks of material misstatement at financial statement level</p> <p>6.2 Overall responses to risks of material misstatements at assertion level</p> |

Learning focus

Audit planning is a very important part of the audit process because it sets the direction for the audit, based on an assessment of the risks relevant to the entity.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.05	Planning and risk assessment	3
2.05.01	Identify and explain:	
2.05.01.01	The need for planning an audit	
2.05.01.02	The contents of the overall audit strategy and the audit plan	
2.05.01.03	The relationship between the overall audit strategy and the audit plan	
2.05.02	Develop and document an audit plan	
2.05.03	Explain how auditors obtain an initial understanding of the entity and its environment including the use of preliminary analytical review procedures	
2.05.04	Explain the components of audit risk	
2.05.05	Assess the risk of material misstatement at the financial statement level and assertion level	
2.05.06	Recognise and suggest overall responses to assessed risk	
2.05.07	Recognise and suggest specific procedures to respond to assessed risks	
2.07	Documentation	3
2.07.01	Document an audit plan	
2.08	Materiality	3
2.08.01	Define materiality and demonstrate how it should be applied in the context of financial reporting and auditing	

1 Audit planning



Topic highlights

Auditors must plan their work so that it is undertaken in an effective manner. The auditors formulate an **overall audit strategy** which is translated into a **detailed audit plan** for audit staff to follow.

HKSA 300.2,
4, 6

1.1 The importance of planning

An effective and efficient audit relies on proper planning procedures. The planning process is covered in general terms by HKSA 300 (Clarified) *Planning an Audit of Financial Statements* which states that the objective of the auditor is to plan the audit so that the engagement is performed in an effective manner.

Auditors should undertake the following:

- (a) Plan the audit to enable it to be carried out in the most effective and efficient manner
- (b) Consider whether to continue the entity relationship in the case of an existing entity
- (c) Ensure the terms of the engagement are understood
- (d) Consider ethical guidance including independence
- (e) Consider entity acceptance procedures and professional clearance
- (f) Establish the overall audit strategy for the audit and update any changes during the course of the audit
- (g) Develop and document an overall audit strategy for the expected scope and conduct of audit in order to reduce audit risk to an acceptably low level
- (h) Develop and document an audit plan which sets out the nature, extent and timing of planned audit procedures

The audit strategy and plan should be revised during the audit when there are changes in conditions or unexpected results are obtained.

Adequate planning benefits the audit in the following ways:

- Helping the auditor to devote appropriate attention to important areas of the audit
- Helping the auditor identify and resolve potential problems on a timely basis
- Helping the auditor properly organise and manage the audit engagement so that it is performed in an effective and efficient manner
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them
- Facilitating the direction and supervision of engagement team members and the review of their work
- Assisting, where applicable, in co-ordination of work done by auditors of components and experts.

Audit procedures should be discussed with the entity's management, staff and/or audit committee in order to co-ordinate audit work, including that of internal audit. However, all audit procedures remain the responsibility of the external auditors.

1.1.1 Preliminary engagement activities

Planning activities establish an **overall audit strategy** for the engagement and develop an **audit plan** in order to reduce audit risk to an acceptably low level.

HKSA 300 (Clarified) requires that, at the beginning of the current audit engagement, the auditor must perform the following preliminary engagement activities:

- Perform procedures regarding the continuance of the client relationship and the specific audit engagement (HKSA 220 (Clarified))
- Evaluate compliance with ethical requirements such as independence (HKSA 220 (Clarified))
- Establish an understanding of the terms of the engagement (HKSA 210 (Clarified))

Performing the preliminary engagement activities assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

1.2 The audit strategy and the audit plan



Key term

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

HKSA
300.7-12

Each entity is unique and an audit strategy should be adapted to suit the particular requirements and characteristics of the entity concerned. A strategy should be derived from the audit engagement partner's understanding of the entity and its particular environment, which indicate where the most significant risks of misstatements lie. The audit partner's responsibilities in this regard are set out in HKSA 315 (Revised) – see below.

However, there are common elements to all strategies which are presented in the table that follows:

The audit strategy: matters to consider

Characteristics of the engagement	<ul style="list-style-type: none"> • Relevant financial reporting framework • Industry regulation • Expected scope of audit • Characteristics of business segments • Availability of internal audit staff and work performed • Use of service organisations • Effect of information and communications technology on audit procedures • Availability of entity staff and information
Reporting objectives, timing of the audit and nature of communications	<ul style="list-style-type: none"> • Entity's timescale for reporting and accounting policies • New accounting standards • Organisation of meetings with management and those charged with governance • Discussions with management and those charged with governance • Expected communications with third parties

The audit strategy: matters to consider

Significant factors, preliminary engagement activities, and knowledge gained on other engagements	<ul style="list-style-type: none"> • Determination of materiality • Areas identified with higher risks of material misstatement • Results of previous audits • Need to maintain professional scepticism • Evidence of management's commitment to design, implementation and maintain sound internal controls • Volume of transactions • Significant business developments • Significant industry developments and conditions • Significant changes in the financial reporting framework • Other significant recent developments • Any going concern issues
Nature, timing and extent of resources	<ul style="list-style-type: none"> • Selection of engagement team • Assignment of work to team members • Engagement budget



Key term

HKSA 300.9

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

The audit plan shall include the following:

- (a) A description of the nature, timing and extent of planned risk assessment procedures
- (b) A description of the nature, timing and extent of planned further audit procedures at the assertion level
- (c) Other planned audit procedures required to be carried out for the engagement to comply with HKSAs

The planning for these procedures occurs over the course of the audit as the audit plan develops.

Any changes made during the audit engagement to the overall audit strategy or audit plan, and the reasons for such changes, shall be included in the audit documentation.

1.2.1 Documenting the audit plan

The auditor should document the overall audit strategy and the audit plan, including any significant changes made during the audit engagement.

The auditor's documentation of the audit plan is **sufficient to demonstrate the planned nature, timing and extent of risk assessment procedures**, and further audit procedures at the assertion level for each material class of transaction, account balance, and disclosure in response to the assessed risks.

Standard audit programmes or completion checklists could be used by the auditor who should appropriately tailor them to reflect the particular engagement circumstances.

The auditor's documentation of any **significant changes to the originally planned overall audit strategy** and to the **detailed audit plan** includes the reasons for the significant changes and the auditor's response to the events, conditions, or results of audit procedures that resulted in such changes. A record of the significant changes to the overall audit strategy and the audit plan, and

resulting changes to the planned nature, timing and extent of audit procedures, explains the overall strategy and audit plan finally adopted for the audit and demonstrates the appropriate response to significant changes occurring during the audit.

The form and extent of documentation depend on such matters as the size and complexity of the entity, materiality, the extent of other documentation, and the circumstances of the specific audit engagement.

HKSA 210.3, 6

1.3 Agreeing the terms of audit engagement

In accordance with HKSA 210 (Clarified) the objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

- establishing whether the pre-conditions for an audit are present
- confirming that there is a common understanding between auditor and management or those charged with governance of the terms of the audit engagement

1.3.1 Preconditions for an audit

Preconditions for an audit are the use by management of an acceptable **financial reporting framework** for preparation of its financial statements and the agreement by management and those charged with governance on which an audit is conducted.

The auditor must:

- (a) determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable
- (b) obtain the agreement of management that it acknowledges and understands its responsibility:
 - for the preparation of financial statements in accordance with the applicable financial reporting framework
 - for establishing the internal controls necessary for enabling the preparation of financial statements free from material misstatements
 - for providing the auditor with access to information, any additional information upon request and unrestricted access to persons within the entity for audit evidence

1.3.2 Agreeing terms with management or those charged with governance

The auditor must agree the terms of the audit engagement with management or those charged with governance. The agreed terms of the audit engagement include matters such as:

- (a) the objective and scope of the audit of the financial statements;
- (b) the responsibilities of the auditor and management;
- (c) identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (d) reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content. This may be done in an engagement letter or any suitable form of written agreement.

2 Understanding the entity and its environment



Topic highlights

The auditor is required to obtain an **understanding** of the entity and its environment in order to be able to assess the risks of material misstatement.

HKSA 315.3

2.1 Why understanding is important

Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with HKSAs. The main standard we are concerned with here is HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*. This standard was revised in July 2012 and is effective for audits of financial statements for periods ending on or after 15 December 2013. The main changes relate to the way in which the work of the internal audit function affects the auditor's understanding of the entity and the risk assessment process. The additional material included in the revised HKSA is covered in section 2.2 below.

HKSA 315 (Revised) states that the objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

HKSA 315.5-6

The auditor must perform **risk assessment procedures** to provide a basis for the identification and assessment of the risks of material misstatement at the financial statement and assertion levels. These must include:

- Inquiries
- Analytical procedures
- Observation and inspection



Key term

Risk assessment procedures are audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion level.

The auditor must gather, review and analyse information through observation, inquiry and discussion to create a picture of the whole entity in order to understand the particular risks the entity faces, whether these are from its internal structure and control systems (fraud, human error, aggressive targets putting management under undue pressure, high volume of transactions or inexperienced staff) or the wider environment (political, technological, economic or market factors which may expose the business to unforeseen challenges or uncertainty).

With this information, the auditor may then develop appropriate procedures in order to ascertain where the most significant risks of material misstatement lie. Auditors may use data from prior periods and knowledge built up from previous audits, but must evaluate the information for current reliability.

The following table provides a simple summary of this important point:

Obtaining an understanding of the entity and its environment

Why?	<ul style="list-style-type: none"> • To identify and assess the risks of material misstatement in the financial statements whether due to fraud or error other factors • To enable the auditor to design and perform further audit procedures • To provide a frame of reference for exercising audit judgment, for example, when setting audit materiality and identifying special audit areas • To evaluate sufficient and appropriate audit evidence • To develop expectations for use when performing analytical procedures
What?	<ul style="list-style-type: none"> • Industry, regulatory and other external factors, including the applicable financial reporting framework • Nature of the entity, including operations, ownership and governance, investments, structure and financing • Entity's selection and application of accounting policies • Objectives and strategies and related business risks that might cause material misstatement in the financial statements • Measurement and review of the entity's financial performance • Internal control • Control environment • Entity's risk assessment process • Information system • Entity's communication of financial reporting matters • Control activities relevant to the audit • Activities to monitor internal control over financial reporting
How?	<ul style="list-style-type: none"> • Inquiries of management, the internal audit function and others within the entity • Analytical procedures to highlight areas of high risk • Observation and inspection of activities and operations of the entity • Prior period knowledge • Entity acceptance or continuance process • Discussion by the engagement team of the susceptibility of the financial statements to material misstatement and the application of the applicable financial reporting framework • Information from other engagements undertaken for the entity • Reconsider the nature, extent and timeliness of substantive testing



Key term

HKSA 520.4

Analytical procedures consist of the evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. They also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

2.2 Impact of the internal audit function

As explained in 2.1 above, the HKSA 315 (Revised) considers the way in which the internal audit function affects this stage of the audit. The key points it makes in respect of this are as follows:

HKSA 315.A6
- A13

2.2.1 Risk assessment procedures and related activities

Inquiries of management, the internal audit function and others within the entity

- Apart from obtaining information from management and those responsible for financial reporting, the auditor can obtain information through inquiries with the internal audit function, if the entity has such a function, and others within the entity.
- HKSA 260 (Clarified) identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed towards in-house legal counsel may provide information about litigation, compliance with laws and regulations etc.
- Inquiries of marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends or contractual arrangements with customers.
- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.
- As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

Inquiries of the internal audit function

If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels.

In performing its work, the **internal audit function** is likely to have:

- obtained insight into the entity's operations and business risks,
- findings based on its work, such as **identified control deficiencies or risks**, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit.

Inquiries of particular relevance may be about matters **the internal audit function** has raised with those charged with governance and the outcomes of the function's own risk assessment process.

If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function.

In addition, according to **HKSA 240 (Clarified)**, if the internal audit function provides information to the auditor regarding **any actual, suspected or alleged fraud**, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.

Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have **the appropriate**:

- **knowledge**
- **experience**
- **authority**

This will normally include the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities

Auditors of public sector entities often have **additional responsibilities** with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material non-compliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

Audit evidence for elements of the control environment

The auditor may also consider how management has **responded to the findings and recommendations of the internal audit function** regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

HKSA 315.A109
- A116

2.2.2 The entity's internal audit function

- If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the **entity's monitoring of internal control** over financial reporting. This understanding, together with information obtained from inquiries of management can assist the auditor in identification and assessment of the risks of material misstatement.
- The **responsibilities** of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding **the design and effectiveness of risk management, internal control and governance processes**. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting.
- The auditor's inquiries of appropriate individuals within the internal audit function may help the auditor obtain an **understanding of the nature of the internal audit function's responsibilities**. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.
- If the nature of the internal audit function's responsibilities and assurance activities are **related to the entity's financial reporting**, the auditor may also be able to use the work of the internal audit function to **modify the nature or timing, or reduce the extent**, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.

- If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, **HKSA 610 (Revised 2013)** applies.
- As is further discussed in HKSA 610 (Revised 2013), the activities of an internal audit function are **distinct from other monitoring controls** that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.
- **HKSA 200 (Clarified)** discusses the importance of the auditor planning and performing the audit with professional scepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, **communication with the internal audit function** throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.



Self-test question 1

In performing an audit of financial statements, auditors should have or obtain knowledge of the business sufficient to enable them to identify and understand the events, transactions and practices that, in the auditors' judgment, may have a significant effect on the financial statements or on the audit or the auditors' report.

Required

- State how obtaining an understanding of the entity can assist the auditor in the planning of an audit engagement.
- Assume that you have been recently appointed as an auditor of a large electronic manufacturing company in Hong Kong with subsidiary operations in Guangzhou. Discuss some of the matters you would consider in obtaining knowledge of the business under the following headings:
 - General economic factors;
 - the industry; and
 - the entity

(The answer is at the end of the chapter)

3 Materiality



Topic highlights

Materiality should be calculated at the **planning stages of all audits**. The calculation or estimation of materiality should be based on experience and judgment.

Materiality should be **reviewed** throughout the audit and revised if necessary. An item might be material due to its nature, value or impact on the readers of the financial statements.

Assessing whether an omission or misstatement may influence the decision-making by users, requires consideration of the characteristics of those users and how the information may be used.

3.1 Applying materiality in the context of financial reporting and auditing

The objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. Therefore, the auditor is required to identify and assess the risks of material misstatements in the audit process.

The consideration of materiality is divided into:

HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit* – materiality in planning and performing an audit of financial statements; and

HKSA 450 (Clarified) *Evaluation of Misstatements Identified during the Audit* – materiality in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial statements.

The auditor has to satisfy both HKSAs.

3.1.1 Materiality in the context of an audit

The objective of the auditor is to apply the concept of materiality in planning and performing the audit and to evaluate the effect of identified and uncorrected misstatements on the financial statements. The auditor's determination of materiality is a matter of professional judgment.

3.1.2 Materiality in the context of financial reporting

A financial reporting framework such as the HKFRS, discusses the concept of materiality in the context of the preparation and presentation of financial statements. The concept of materiality is discussed differently in different financial reporting frameworks.

For example, in HKSA 1 (Revised), materiality is defined as follows:

'Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor'.

3.2 Purposes for setting materiality levels in the context of an audit of financial statements



Key term

Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

HKSA 320.2,
5-6

In the context of the audit:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements
- Judgments about materiality are made in the light of surrounding circumstances and are affected by the size and/or nature of a misstatement
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users (not the effect on specific individual users)

Auditors need to use professional judgment in determining materiality. The level of materiality is affected by the auditor's perception of the financial information needs of the users of the financial statements.

The concept of materiality is applied by the auditor in:

- (a) planning and performing the audit;
- (b) evaluating the effect of identified misstatements on the audit;
- (c) evaluating the effect of uncorrected misstatements on the financial statements ie the nature of the uncorrected misstatements; and
- (d) forming the opinion in the auditor's report.

3.2.1 Materiality in audit planning

Materiality considerations during **audit planning** are extremely important. The assessment of materiality at this stage should be based on the most recent and reliable financial information and will help to determine an effective and efficient audit approach.

Materiality assessment will help the auditors to decide:

- (a) the **cut off point** on how much information should be obtained (**quantity**) and what **type** of information is relevant (**nature**)
- (b) whether to use **sampling techniques**
- (c) what **level of error** is likely to lead to a qualified audit opinion. It serves the objective of audit – ie express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

The resulting combination of audit procedures should help to reduce audit risk to an appropriately low level.

HKSA 320 (Clarified) requires an auditor to determine at least two types of materiality in planning an audit:

- (a) Materiality for the financial statements as a whole; and
- (b) Performance materiality

3.2.2 Materiality and its relationship with audit risk

Auditors should consider **materiality and its relationship with audit risk** in conducting the audit. Auditors should plan and perform the audits so as to provide them with sufficient (quantity) evidence to give reasonable assurance that the financial statements are free from material misstatement and give a true and fair view.

Auditors should consider materiality when determining the nature, extent and timeliness (NET) of audit procedures. Auditors need to consider both materiality levels for quantity and quality factors, therefore it is necessary to set an acceptable materiality level as the benchmark.

There is an **inverse relationship** between materiality and the level of audit risk – the higher the materiality level, the lower the audit risk and *vice versa*.

3.2.3 Materiality in misstatements identified

Auditors should assess whether the **aggregate of uncorrected misstatements** that have been identified during the audit is material in all aspects when evaluating whether the financial statements have been prepared within an applicable financial reporting framework. **We will discuss this further when studying HKSA 265 (Clarified) in Chapter 15.**

If the auditor has identified a material misstatement resulting from error, the auditor should communicate the misstatements to the appropriate level of management and consider the need to report it to those charged with governance in accordance with HKSA 260 (Clarified).

3.3 Materiality for the financial statements as a whole

HKSA 320.10

HKSA 320 (Clarified) states that the auditor, using professional judgment, shall determine materiality for the financial statements as a whole, when establishing the overall audit strategy. Materiality at the overall statement level may be different from the assertion level depending on the specific risks identified. A chosen benchmark such as profit before tax, gross profit or net asset value could be taken as a starting point to determine the materiality for the financial statements as a whole.

3.4 Materiality for the particular classes of transactions, account balances or disclosures

HKSA 320.A10

Auditors shall determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures that are expected to be influential to the users of financial statements. Where misstatements of lesser amounts than materiality for the financial statements as a whole could affect the economic decisions of users, materiality levels for those particular balances must be set. In deciding whether this is necessary auditors should consider:

- whether law, regulations or the applicable financial framework affect users
- the key disclosures in relation to the industry in which the entity operates
- whether separate disclosure in the financial statements is required

3.5 Performance materiality



Key term

HKSA 320.9

Performance materiality means the amount 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. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Planning the audit solely to detect individually material misstatements fails to take into account the aggregated effect of individually immaterial misstatements on the overall financial statements.

The auditor is therefore required to determine **performance materiality** for purposes of:

- assessing the risks of material misstatement; and
- determining the nature, timing and extent of further audit procedures

It may relate to a particular class of transactions, account balance or disclosure.

As for the determination of materiality at the financial statement level, there is no single formula for performance materiality.

The determination of performance materiality involves the exercise of professional judgment and is affected by:

- the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and
- the nature and extent of misstatements identified in previous audits and the auditor's expectations in relation to misstatements in the current period.

If the auditor concludes that a **lower materiality** than that initially determined is appropriate for the financial statements as a whole, the auditor must determine:

- whether it is necessary to revise performance materiality, and
- whether the nature, extent and timing of the further audit procedures remain appropriate



Self-test question 2

J Limited (“J”) is a listed entity with a wide spread of shareholders. The entity is engaged in the manufacture and trading of civil engineering products. Your firm has been the auditor of J for the past five years, and has not encountered any significant audit problems during this period. J has been operating with its present entity structure and its basic product range for the past three-and-a-half years. The entity has built a strong reputation in the market place based on its astute, conservative management style and quality product range. The “geotextile” products, targeted mainly at the road construction market, which represent 40% of J’s revenue, have come under heavy competition in the last six months, eroding J’s profit margins on these products significantly.

The following is a summary of J’s key financial data:

Year	Revenue \$m	Operating profit \$m	Total assets \$m	Net assets \$m
20Y0	1,324	56	1,555	755
20X9	1,266	72	1,494	685
20X8	1,275	90	1,617	615
20X7	1,512	78	1,387	580
20X6	1,739	67	1,629	605

Required

Determine the audit planning materiality figure to be adopted in the audit of J’s financial statements for the year ended 31 December 20Y0. Discuss and justify your selection of the key financial data used as bases for the materiality calculations and the percentages applied to these bases.

(The answer is at the end of the chapter)

4 Risk

4.1 Audit risk



Topic highlights

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It is a function of the risk of material misstatement (**inherent risk** and **control risk**) and the risk that the auditor will not detect such misstatement (**detection risk**).



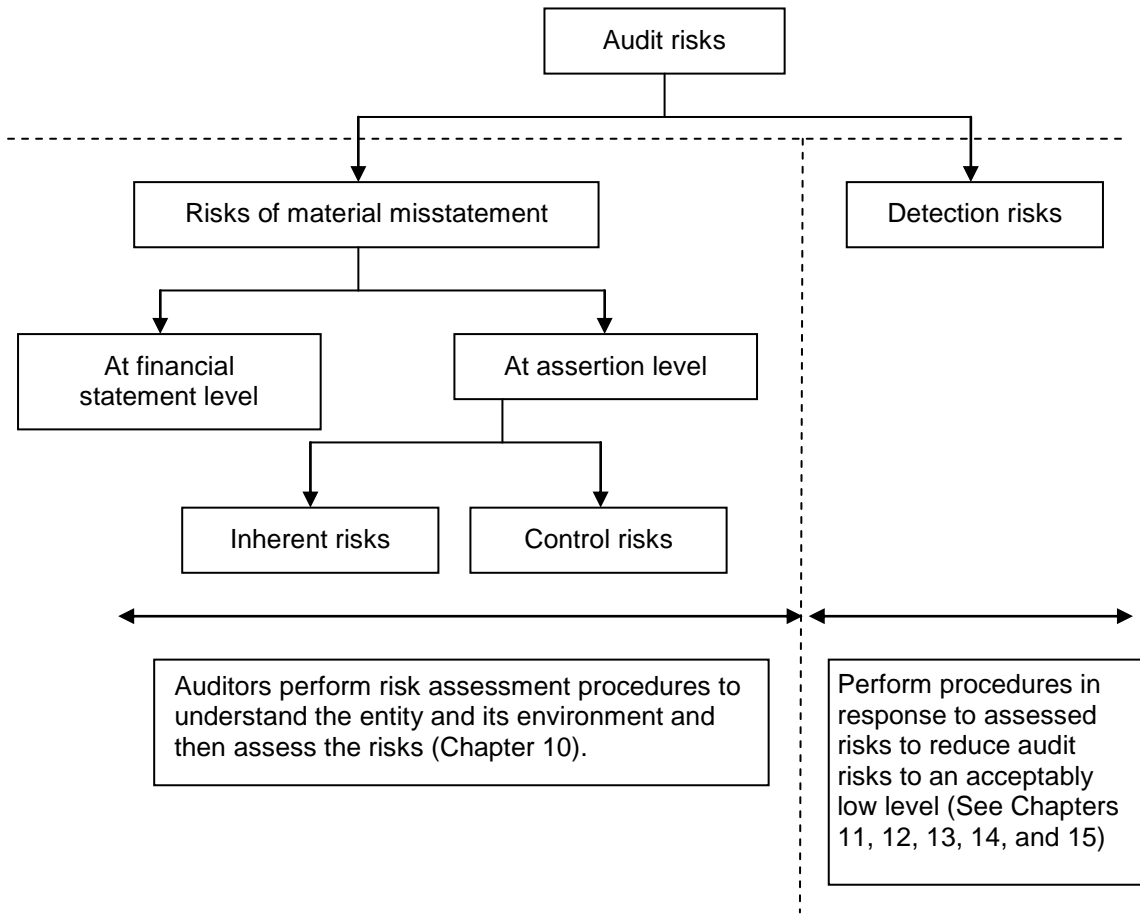
Key term

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

HKSA
200.13c

Audit risk has two major components. One is dependent on the entity, and is the risk of material misstatement arising in the financial statements (**inherent risk** and **control risk**). The other is dependent on the auditor, and is the risk that the auditor will not detect material misstatements in the financial statements (**detection risk**).

Audit risk can be represented by the **audit risk model**:



4.1.1 Inherent risk



Key term

Inherent risk (IR) is the susceptibility of an assertion about a class of transactions, account balance or disclosure to a misstatement that could be material either individually or when aggregated with other misstatements, before consideration of any related controls.

HKSA
200.13n

Inherent risks exist on two levels: at the entity level and for single items or balances, where there is a significant risk of misstatement (assertion level). The risk of misstatement may be through error particularly in the cases of very complex transactions, an inexperienced management team or lax internal controls. Examples include the temptation to overstate sales in order to increase revenue, or wrongful timing of revenue recognition and so forth.

The level of inherent risk is affected by the nature of the entity; the experience and ethos of its management; the industry within which it operates; the degree to which that industry is regulated; and also the strategies it chooses to pursue.

The degree of inherent risk is a matter for the auditors' professional judgment which must be based on their understanding of the entity, its management, the nature of its transactions and the reliability of the accounting systems. Where knowledge is limited then the inherent risk is deemed to be **high**.

Factors affecting the entity

Integrity and risk profile of senior management	Domination by a powerful individual may cause problems
Management quality and experience	Changes in management and quality of financial management
Aggressive targets put pressure on management	Examples include tight reporting deadlines, or market or financing expectations
Profile of product or service offering	Potential problems include technological obsolescence or over-dependence on single product
Industry environmental factors	Competitive conditions, regulatory requirements, technological developments, sudden drop or rise in customer demand
Information and communications technology	Problems include lack of supporting documentation, concentration of expertise in key people, or unauthorised access

Factors affecting individual account balances or transactions (assertion level)

Financial statement accounts prone to misstatement	The risk is particularly high for complex transactions or balances that require a high degree of estimation or where internal control and systems are unreliable
Complex accounts	Accounts which require expert valuations or are subjects of current professional discussion may be considered complex
Assets at risk of being lost or pilfered	Cash, inventory, portable non-current assets (such as notebook computers)
Quality of accounting systems	This depends on the controls over and competence and efficiency of individual departments (sales, purchases, cash etc)
High volume transactions	The accounting system may have problems coping with sudden peaks in demand
Unusual transactions	Transactions for large amounts, with unusual names, or which are not settled promptly (recognition problems particularly likely if they occur at the end of the reporting period) Transactions processed outside of the system, which may relate to specific entities or which are processed by particular individuals and therefore are not subject to usual internal process controls
Staff	Structural or technological changes, key people leaving, changes to working terms or conditions may all lead to low morale and a higher risk of fraudulent or careless behaviour

4.1.2 Control risk

The second element of the risk of material misstatement in the financial statements is control risk.



Key term

Control risk (CR) is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure 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 controls.

HKSA
200.13n

A **preliminary assessment of control risk** at the planning stage of the audit is required to determine the level of controls and substantive testing to be carried out. The Canadian Institute of Chartered Accountants' ("CICA") Research Study "Extent of Audit Testing" identified four major factors affecting the level of control risk and they are as follows:

- (a) **Evaluation of internal control.** In general, the stronger the internal controls, the lower the risk. After the assessment of control risk, auditors should carry out tests of control to obtain reasonable assurance that the internal controls on which they intend to rely are operating effectively during the reporting period. Controls testing will be examined in more detail in Chapter 11.
- (b) **Work performed by internal and other auditors.** If the audit client has an internal audit function and the auditors decided to rely on the work performed by the internal auditors after the assessment, the control risk can be adjusted to lower. In addition, if the auditor can rely on the work performed by another independent auditor in the case of subsidiaries or branches, the control risk can also be lowered. Use of the work of others will be discussed further in Chapter 14.
- (c) **The nature of audit trail.** As defined by CICA, audit trail refers to the documentary evidence either of compliance with internal control procedures or of the transfer of accounting information from its point of origin through intermediate records to its final inclusion in the general ledger. Lack of audit trail suggests high control risk.
- (d) **Computerised accounting system.** The existence of such a system and the use of the computer as an audit tool will affect the assessment of control risk made by the auditor. We will discuss this further in Chapter 20.

4.1.3 Detection risk



Key term

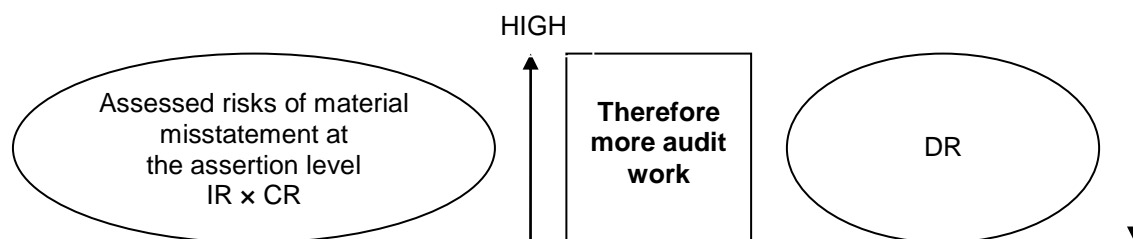
Detection risk (DR) is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

HKSA
200.13e

The third element of audit risk is detection risk. This is the component of audit risk over which the auditors have a degree of control, because, if risk is too high to be tolerated, the auditors can carry out more work to reduce this aspect of audit risk. **Sampling risk** and **non-sampling risk** are relevant and will be examined later.

Detection risk relates to the inability of the auditors to examine all evidence. Audit evidence is usually persuasive rather than conclusive so some detection risk is usually present, allowing the auditors only to seek "reasonable assurance" not absolute assurance. Detection risk relates to the nature, timing and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.

There is an inverse relationship between IR and CR versus DR.



4.2 Business risk



Topic highlights

Business risk is the risk arising to the entity through being in operation.



Key terms

HKSA 315.4b

Business risk is the risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies. It is split into three categories:

Financial risks are the risks arising from the financial activities or financial consequences of an operation, for example, cash flow issues or overtrading.

Operational risks are the risks arising with regard to operations, for example, the risk that a major supplier will be lost and the entity will be unable to operate.

Compliance risk is the risk that arises from non-compliance with the laws and regulations that surround the business.

Business risk includes all risks facing the business. In other words, inherent audit risk may include business risks.

In response to business risk, the directors institute a system of controls. These will include controls to mitigate against the financial aspect of the business risk. These are the controls some of which control risk incorporates.

Therefore, although audit risk is very financial statements focused, business risk does form part of the inherent risk associated with the financial statements, not least, because if the risks materialise, the going concern basis of the financial statements could be affected.

5 Risk assessment



Topic highlights

When the auditor has obtained an understanding of the entity, he shall identify significant risks and assess the risks of material misstatement in the financial statements.

HKSA 315.25

5.1 Identifying and assessing the risks of material misstatement

HKSA 315 (Revised) says that the auditor shall identify and assess the risks of material misstatement at the **financial statement level and at the assertion level** for classes of transactions, account balances and disclosures.

It requires the auditor to take the following steps:

- Step 1** Identify risks throughout the process of obtaining an understanding of the entity and its environment.
- Step 2** Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole.
- Step 3** Relate the risks to what can go wrong at the assertion level.
- Step 4** Consider the likelihood of the risks causing a material misstatement.



Key term

HKSA 315.4a

Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditors to consider the different types of potential misstatements that may occur. We look at these in detail in Chapter 9.

Auditors should determine risks that require **special audit consideration (“significant risks”)** and consider whether controls are implemented to mitigate these risks.

Auditors should evaluate the design of the entity's controls and should determine the implementation of the entity's controls. If it is not possible or impracticable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained by substantive testing, then the auditor should evaluate the design and implementation of the entity's controls.

5.2 Risks of material misstatement at financial statement level or assertion level

As said in the previous section, under HKSA 315 (Revised), auditors should identify and assess the risks of material misstatement at the **financial statement level and at the assertion level** for classes of transactions, account balances and disclosures.

So what is the difference between the two levels? The two can be contrasted in the following table:

Differences between financial statement level and assertion level

At the financial statement level	At the assertion level
<ul style="list-style-type: none"> • Applying to the financial statements as a whole • Able to reduce audit risk to an acceptably low level • More pervasive to the financial statements as a whole • Affect many assertions • Risks from a deficient control environment which includes management's attitudes towards good internal control practice • Deficiencies in controls, in particular of management's lack of competence • Aggressive business strategies • Significant business risk: such as fraud • Complexity of business operation • High pressure on performance measures and reviews • Cannot focus on a specific risk • Concern about the entity as a going concern 	<ul style="list-style-type: none"> • Not able to reduce the risks of material misstatement to an acceptably low level with audit evidence obtained only from substantive procedures • Refer to specific classes of transactions, accounts balances • Risks arise from the particular characteristics of a class of transaction • Identify controls that are likely to prevent, detect or correct material misstatements • Comprises of inherent risk and control risk (Combined assessment of the risk of material misstatement) • Auditor would perform tests of controls to support the risk assessment

Differences between financial statement level and assertion level

Factors to consider

- Management integrity
- Management experience and knowledge
- Unusual pressures on management (ie plan to go public, bonuses tied to sales or profits)
- Nature of entity's business
- Industry factors ie special regulations and reporting changes

Factors to consider

- Accounts likely to be susceptible to misstatements (ie required many adjustments in previous year's audit or accounts that include estimated amounts)
- Complexity of underlying transactions (eg financial instruments)
- Degree of judgment involved in determining account balances (eg provision for contingent liabilities and warranty expenses)
- Susceptibility of assets to loss or misappropriation
- Completion of unusual transactions particularly near the year end
- Transactions not subject to ordinary processing ie special treatment of transaction (significant risk)

5.3 Significant risks



Topic highlights

Significant risks are complex or unusual transactions that may indicate fraud, or other risks or are unusual in their characteristics. Routine and non-complex transactions are less likely to give rise to significant risk than unusual transactions.



Key term

Significant risks are those that require special audit consideration.

HKSA 315.4e

Significant risks are often related to:

- non-routine transactions
- judgmental matters

HKSA
315.27-29

5.3.1 Significant risks relating to non-routine transactions

Non-routine transactions are transactions which occur occasionally due to either their size or nature. They are deemed to be of significant risk because there is more:

- management intervention or overriding in accounting treatment;
- complex accounting principles or calculations;
- manual intervention for data collection and processing; and
- opportunity for control procedures not to be followed.

5.3.2 Significant risks relating to judgmental matters

Risks of material misstatement may be greater for matters that require the use of accounting estimates which involve a degree of uncertainty. Auditors must consider:

- whether accounting principles for accounting estimates have been followed;
- possible interpretations of revenue recognition, and how management may have construed the transaction;
- that the judgment used may be subjective or complex (or unduly optimistic as to the outcome!); and
- the basis for any assumptions about the effects of future events such as fair value.

Where there is a significant risk the auditor must thoroughly investigate the entity's controls pertaining to that risk.

5.4 Automation risk

Many companies have taken advantage of the huge strides in information and communications technology to automate the processing of routine transactions, resulting in little or no manual intervention, with the result that there is no longer a physical audit trail. Where audit evidence exists only in electronic form, the auditors should concentrate on tests of controls rather than substantive procedures.



Self-test question 3

Nepco is a European entity that manufactures high quality computer components and assembles computer parts. It has existed for some years and is part of a vertical supply chain for a well-known brand of computer hardware. Profits are coming under increasing pressure from manufacturers in the Far East and Asia with lower labour costs, and from rising raw material costs. Nepco is listed on a stock exchange. There is pressure from institutional investors for better returns in the form of dividends and the main institutional investors are considering selling a proportion of their shares in the entity. The directors of Nepco are considering whether to move into new market areas.

Nepco has good accounting and internal control systems. Inventory is material to the financial statements, and there is a good set of permanent inventory records. No year-end inventory count is conducted. Operational compliance issues are important to Nepco. Many countries have inflexible quality standards and some projects are being held up because of difficulties in obtaining approval from regulators for new components.

All staff and directors of Nepco are remunerated (at least in part) on a performance-related basis, some with share options. Staff are generally highly qualified and well paid. This is your first year as auditors. Your firm has very little experience in this industry. External audit costs are tightly controlled and your firm has agreed to a budget that will allow very little flexibility.

Required

Describe the risks relating to Nepco under the headings of inherent risk, control risk and detection risk.

(The answer is at the end of the chapter)

6 Overall responses to assessed risk of material misstatement



Topic highlights

The overall audit strategy and detailed audit plan may need to be revised to address the assessed risk of material misstatement.

6.1 Overall responses to risks of material misstatement at financial statement level

HKSA 330.5

Under HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks*, **overall responses** include issues such as emphasising to the team the importance of professional scepticism, allocating more staff, using experts or providing more supervision.

Overall responses to address the risks of material misstatement at the financial statement level will be changes to the general audit strategy or re-affirmations to staff of the general audit strategy in order to reduce the audit risk to an acceptably low level. Documentation is required.

For example:

- Emphasising to audit staff the need to maintain professional scepticism
- Assigning additional or more experienced staff to the engagement team
- Providing more training to audit staff
- Providing more supervision on the audit
- Incorporating more unpredictability into the audit procedures
- Making general changes to the nature, timing or extent of audit procedures
- Consider the use of expert
- Collect more pervasive evidence

The evaluation of the control environment that will have taken place as part of the assessment of the entity's internal control systems will help the auditor determine what type of audit approach to take.

Some general guidelines

Risk at financial statement level is low

- No specific additional response
- Maintain professional scepticism

Risk at financial statement level is normal to medium

- Remind the engagement team to maintain professional scepticism
- Assign more experienced staff
- Budget in more review and supervision
- Consider resigning from the engagement

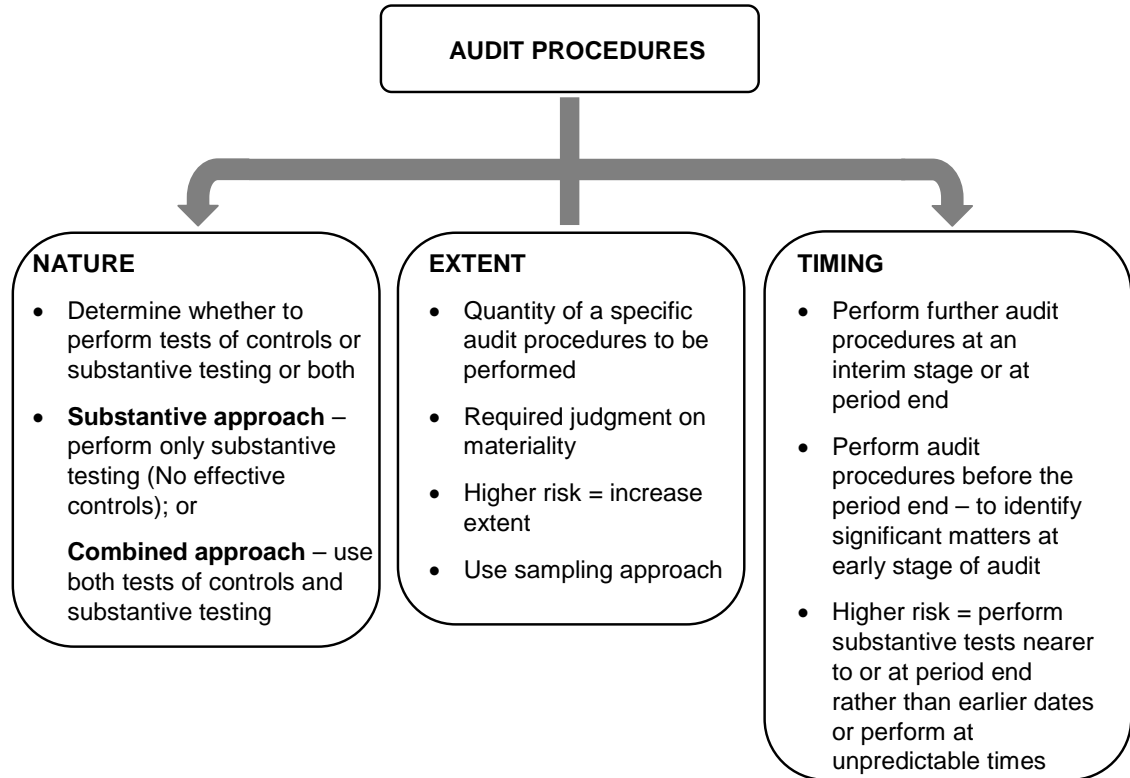
Risk at financial statement level is high

- Remind the engagement team to maintain professional scepticism
- Assign more experienced staff
- Budget more review and supervision
- Assign an expert if required, for example if computer fraud is suspected
- Do not rely on entity's internal controls and use substantive procedures only
- Perform audit procedures in unexpected manner
- Consider resignation from engagement

6.2 Overall responses to risks of material misstatements at assertion level

HKSA 330.6-7, 10, 18-19

HKSA 330 (Clarified) says that the auditor shall design and perform further audit procedures whose **nature**, **extent** and **timing** are based on and are responsive to the assessed risks of material misstatement at the assertion level.



6.2.1 Tests of controls



Key term

HKSA 330.4b

Tests of controls are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

When the auditor's risk assessment includes an expectation that controls are operating effectively, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence that the controls are operating in a satisfactory manner.

The auditor shall also undertake tests of controls when it will not be possible to obtain sufficient appropriate audit evidence simply from substantive procedures alone. This might be the case if the entity conducts its business using IT systems which do not produce documentation of the transactions.

In carrying out tests of controls, auditors shall use **inquiry**, among other procedures, such as **re-performance** and **inspection**.

When considering timing in relation to tests of controls, the purpose of the tests will be important.

For example, if the entity carries out a year-end inventory count, controls over the inventory count can only be tested at the year-end. Other controls will operate all year round, and the auditor may need to test that those controls have been effective throughout the period.

Some controls may have been tested in prior audits and the auditor may choose to rely on previous evidence that they are effective. If this is the case, the auditor shall obtain evidence about any

changes since the controls were last tested and shall test the controls if they have changed. In any case, controls shall be tested for effectiveness **at least once in every three audits**.

If the related risk has been designated a significant risk, the auditor shall not rely on testing done in prior years, but shall perform testing in the current year.

6.2.2 Substantive procedures



Key term

HKSA 330.4a

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. They consist of tests of details of classes of transactions, account balances and disclosures, and substantive analytical procedures.

The auditor shall always carry out substantive procedures on material items. HKSA 330 (Clarified) says that irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosures.

In addition, the auditor shall carry out the following substantive procedures:

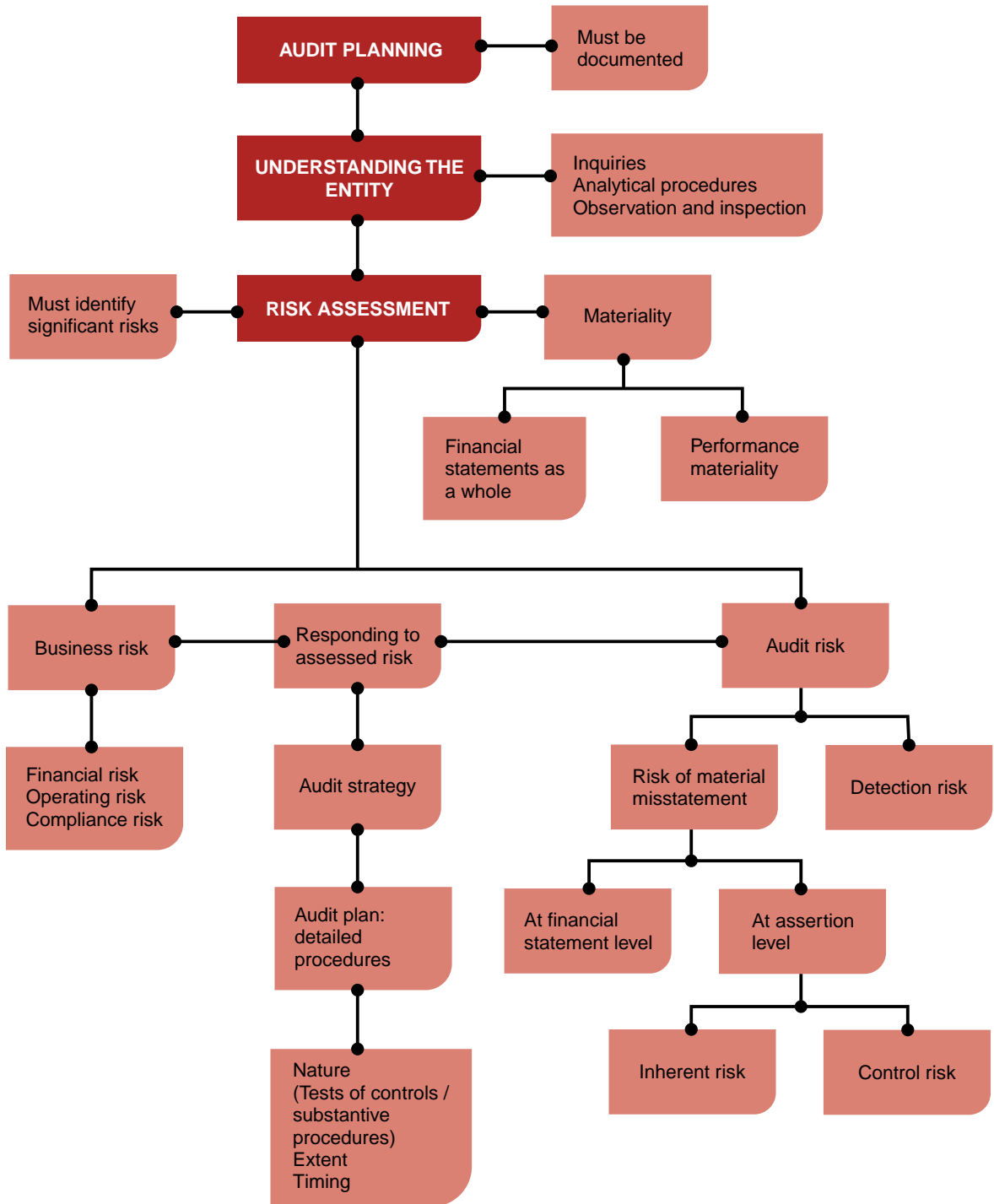
- Agreeing or reconciling the financial statements to the underlying accounting records
- Examining material journal entries
- Examining other adjustments made in preparing the financial statements

Substantive procedures fall into two categories: **substantive analytical procedures and tests of details**. The auditor must determine when it is appropriate to use which type of substantive procedure.

Substantive analytical procedures as substantive procedures tend to be appropriate for large volumes of predictable transactions (for example, wages and salaries). **Tests of details** may be appropriate to gain information about account balances for example, inventory or trade receivables.

Tests of details rather than substantive analytical procedures are likely to be more appropriate with regard to matters which have been identified as **significant risks**, but the auditor must develop procedures that are specifically responsive to that risk, which may include substantive analytical procedures. Significant risks are likely to be the most difficult to obtain sufficient appropriate audit evidence about.

Topic recap



Answers to self-test questions

Answer 1

- (a) Understanding the entity can help the auditor in:
- (i) fully understanding the client's industry, business and organisation
 - (ii) assessing the engagement risks
 - (iii) communicating with client's staff
 - (iv) assessing the reliability of written representations from management
 - (v) determining the appropriateness of accounting policies and disclosures
- (b) (i) General economic factors include:
- general level of economic activity (eg recession, growth etc.)
 - inflation
 - interest rates and availability of financing
 - government policies
 - foreign currency rates
 - commodity prices
- (ii) Industry factors include:
- Market competition
 - Changes in product technology
 - Business risk because of high technology
 - Environmental regulation and problems
- (iii) The entity factors include:
- Beneficial owners and related parties
 - Capital structure including any recent or planned changes
 - Acquisitions, mergers or disposal of business
 - Sources and methods of financing
 - Independence of board of directors

Answer 2

Materiality

There is no "right" answer as the determination of audit planning materiality is a judgment process with only limited professional guidance offered.

The calculation needs to take into consideration both quantitative data (ie financial information, etc) as well as qualitative aspects (eg users, risks, type of industry, etc).

The calculation generally involves a decision as to an appropriate base for materiality. This would mainly be determined by the users (eg if J is listed, then profit will most likely be the key information of interest), industry, the type of operations and other factors which affect the judgment as to which financial information is of key importance and therefore should be the basis for the auditor's materiality decision.

The next important decision relates to the choice of percentage. There are some generally accepted percentage ranges ("rules of thumb") in relation to the most common bases. The major factor in determining the percentage used will be the overall risk of the entity.

Some commonly accepted bases	Typical % ranges	Comments
Profit	5–10% HK\$2.8m – 5.6m	Profit is an appropriate base since the entity has a history of comparatively stable profitability and is listed. The users will consider the profit an important indicator of the performance of the entity and a suitable basis to determine the value of the entity's shares. The average profit over a number of years is a reasonable choice as the base to determine the materiality level in this case.
Revenue	0.5–1.0% HK\$6.6m – 13.2m	Revenue is an important measure of the activities of an entity, it could be a good base to determine the materiality level particularly when the profit is not stable over the years. However, it is a less preferred choice as compared to the profit in this case.
Total assets	0.5–1.0% HK\$7.8m – 15.6m	Over the last two years, the total assets were around 20 % more than the annual revenue, which was a rather significant level of investment in total assets. Total assets may therefore be a suitable base. However, like revenue, it is a less preferred choice as compared to the profit in this case.
Equity (net assets)	1.0–2.0% HK\$7.6m – 15.1m	Over the last few years, the total assets were more than twice of the equity, which indicates that the level of borrowing was relatively significant. Going concern may be an issue. Equity may be a suitable base to determine the materiality level. However, like revenue, it is a less preferred choice as compared to the profit in this case.

Answer 3

Risks

HKSA 315 (Revised) states that audit risk is the product of the risk of material misstatement (inherent risk and control risk) and detection risk.

- (a) The following are some of the inherent risks involved:
- (i) The competition from Asian and Far Eastern entities, and rising raw material prices. This means that there is pressure on profits and the ability to reward employees and pay dividends to institutional shareholders which increases the pressure to manipulate the financial statements to show good returns.
 - (ii) The potentially volatile market (computer components) in which new technology can render hardware obsolete in a very short time. This means that there is an ongoing risk to the business as a whole (a potential going concern risk), the entity must be adaptable.
 - (iii) The risk that regulators may reject a product which has taken many months or years to develop.
 - (iv) The pressures for returns from institutional investors which means that there may be a temptation to manipulate the financial statements.
 - (v) The possible sale of shares, increasing the pressure for returns in order to get the best possible price, which increases the pressure to manipulate the financial statements.

- (vi) The inherent risks in diversification into unknown areas (the supply of other customers) – but these are not current risks.
- (b) Control risks: there are apparently very few except for the performance-related payment, including share options, which provides an incentive to produce acceptable figures.
- (c) Detection risk: this is the firm's first year as auditors and there are tight controls on audit costs, which may lead to inadequate audit evidence unless the audit is properly directed, supervised and reviewed. This is compounded by the firm's lack of experience in this area. It is important that those with experience are employed on this audit, at least in a review capacity.

Exam practice



ABC Industrial Limited

18 minutes
(excluding reading time)

You are the audit manager of a Hong Kong CPA firm, Ng, Tung & Co (“NTC”), and are currently in charge of the audit of ABC Industrial Limited (“ABC”) for the year ended 31 December 20X5. Your firm has been the auditor of ABC since its incorporation in Hong Kong. In the audits of the financial statements of ABC during the last five years, your firm was satisfied with the internal controls of ABC and did not issue any modified opinion on the financial statements.

ABC is a company incorporated in Hong Kong and manufactures a wide range of medium-end cosmetic products. Sales are mainly made to major chain stores and drug retailers in Europe and the USA. ABC is wholly owned by the Cheung family and has a simple management structure. Managers of the respective departments report directly to the Managing Director, Mr Paul Cheung.

During the course of the audit, the following information has come to your attention:

- (1) Due to the rebound of the economy, ABC has seen a significant turnover of accounting staff during the year under review. After six years of service with the company, the manager of the accounts department, Ms Hung, left the company in late November 20X5 and moved to a listed company as a financial controller.
- (2) ABC has adopted a perpetual inventory system. The warehouse staff conduct an interim physical count at the end of every month for 15 % of the stock items on a rotation basis. Except for those which can be properly reconciled, all differences between the book and the physical taking results are adjusted to the results of the physical taking.
- (3) A full physical inventory taking was conducted at the end of the reporting period. Inventory with a book value of approximately HK\$900,000 was written off as a result of this exercise. Members of your engagement team observed the full physical inventory taking at the end of the reporting period and reported that it was properly conducted. However, upon further inquiry, you discovered that all the members of ABC’s “counting team”, which was responsible for the inventory count, were drawn from the warehouse staff. In addition, Mr Wong, the staff member in charge of ABC’s “checking team”, which was supposed to supervise the counting team, was the husband of ABC’s shipping and warehouse manager, Mrs Helen Wong.
- (4) During a meeting with ABC’s financial controller, Ms Guo, you were informed that Mr Wong, a nephew of Mr Paul Cheung, had been working with ABC for more than ten years and was considered to be trust-worthy by ABC’s management. Mr Wong was originally the manager of ABC’s personnel and administration department, and had no involvement in either the sales or purchases of the company previously. Mr Wong was only temporarily assigned to the accounts department upon Ms Hung’s resignation to take over the supervision work of that department until a suitable candidate was found, and thus inevitably became head of the “checking team” during the physical inventory taking. The company has been diligently looking for a replacement for Ms Hung but without any success. Based on Ms Guo’s assessment of the current labour market, it was unlikely that ABC could recruit a suitable accounting manager before the financial statements for the year ended 31 December 20X5 are finalised.
- (5) Your audit assistant was unable to perform certain usual sales and purchases cut-off tests as the books and records of ABC after the year-end had not been written up-to-date due to a shortage of manpower in the accounts department. Your assistant was unable to examine the documentary controls of inventory movements after the period end. As an alternative

test, your audit assistant circularised trade receivables and trade payables that showed significant balances in the ledger at the period end, and reviewed the board minutes after the year-end. The response rates for both the trade receivables and the trade payables circularisation tests were considered to be satisfactory, and your assistant reported that no material discrepancy was found from the confirmation procedures.

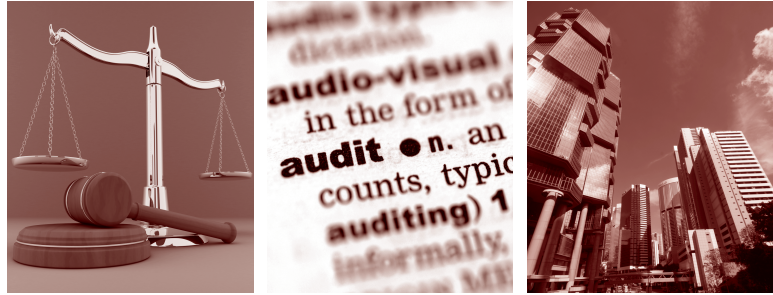
- (6) Since March 20X5, ABC has been exploring the Mainland market by dispatching goods to a number of drug stores in Guangdong Province on a consignment basis. Revenue from these consignment sales is recognised on a monthly basis upon sales information supplied by the respective drug stores, confirming the amount of goods eventually sold to the ultimate customers. Invoices are then issued by ABC to the drug stores. The drug stores are allowed the standard credit period of 60 days, from the invoice issuance date. According to the records, goods with a cost of HK\$5,000,000 have been sent to various drug stores on this basis during the year. In the draft financial statements, ABC recognised revenue of HK\$6,000,000 from these consignment sales. This represents about 10 % of the sales revenue for the year. Consignment goods of HK\$2,000,000 were included as the year-end inventory, representing about 10 % of the total inventory.

Required

Assess the risk of material misstatements at the financial statement level. You should write down the specific circumstances of ABC that you have considered and your judgment about the risk level.

(10 marks)

HKICPA May 2006 (amended)



chapter 9

Audit evidence, procedures, audit methodologies and audit sampling

Topic list

- | | |
|--|---|
| <p>1 Audit evidence</p> <p>1.1 The need for audit evidence</p> <p>1.2 Sufficient appropriate audit evidence</p> <p>2 Financial statement assertions</p> <p>2.1 Audit procedures to obtain audit evidence</p> <p>3 Audit methodologies</p> <p>3.1 Overview</p> <p>3.2 Risk-based audit</p> <p>3.3 'Top-down' approach</p> <p>3.4 Systems audit versus system-based audit</p> <p>3.5 Balance sheet approach</p> <p>3.6 Transaction cycle approach</p> <p>3.7 Directional testing</p> <p>3.8 Cost and performance efficiency of different audit methodologies</p> <p>3.9 Summary of approaches</p> | <p>4 Audit sampling</p> <p>4.1 Introduction to audit sampling</p> <p>4.2 Design of the sample</p> <p>4.3 Sample size and risk</p> <p>4.4 Performing audit procedures on items selected</p> <p>4.5 Deviation or misstatements</p> <p>4.6 Projecting misstatements</p> <p>4.7 Evaluation of sample results</p> <p>5 Audit documentation</p> <p>5.1 Requirement of audit documentation</p> <p>5.2 Reasons for audit documentation</p> <p>5.3 Audit files</p> <p>5.4 Standardised and automated working papers</p> <p>5.5 Safe custody and retention of working papers</p> <p>5.6 Significant matters</p> <p>5.7 Assembly of the final audit file</p> <p>5.8 Changes to audit documentation in exceptional circumstances after the date of the auditor's report</p> |
|--|---|

Learning focus

In this chapter you will study the different types of audit tests used to obtain audit evidence. The tests used and evidence required will depend on the specific balances or transactions being tested and also the areas where a higher risk of misstatement has been identified.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.04	Audit methodologies	3
2.04.01	Describe the key features of the following audit methodologies:	
2.04.01.01	Risk-based auditing	
2.04.01.02	Top-down auditing	
2.04.01.03	System-based auditing	
2.04.01.04	Systems audit	
2.04.01.05	Balance sheet approach	
2.04.01.06	Transaction cycle approach	
2.04.01.07	Directional testing	
2.04.02	Understand the cost and performance efficiency of different audit methodologies	2
2.07	Documentation	3
2.07.02	Explain the need for and the importance of audit documentation	
2.09	Audit procedures	3
2.09.01	Define audit sampling	
2.09.02	Explain the need for sampling	
2.09.03	Apply the basic principles of sampling	
2.09.04	Assess and explain the results of sampling	
2.10	Audit evidence	3
2.10.01	Explain the procedures by which audit evidence may be obtained	
2.10.02	Assess the appropriate and sufficiency (relevance and reliability) of different sources of audit evidence	
2.10.03	Explain the assertions contained in the financial statements and their use in obtaining evidence	

1 Audit evidence



Topic highlights

Auditors must obtain **sufficient appropriate** audit evidence. Audit evidence can be in the form of **tests of controls** or **substantive procedures**.

1.1 The need for audit evidence

HKSA 500.5

Audit evidence is the proof the auditor uses to substantiate an opinion as a result of all the procedures performed. There must be sufficient evidence of suitable quality in order for the auditor to reach a reasonable conclusion on which to base an opinion.



Key term

HKSA 500.5c

Audit evidence is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information

What constitutes audit evidence? Evidence includes the accounting data on which the balances in the financial statements are based, and any other information sought by the auditors, such as confirmations from third parties or management assertions. Audit evidence is cumulative in nature and is obtained from procedures carried out during the course of the audit. It is not expected, or realistic, that auditors might **look at all the information** that exists.

Under HKSA 500 (Clarified) *Audit Evidence*, the auditor is required to:

- obtain **sufficient appropriate audit evidence** to be able to draw reasonable conclusions on which to base the audit opinion;
- ascertain the **accuracy and completeness** of the evidence; and
- use assertions for classes of transactions, account balances and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatements.

It is **management's responsibility** to prepare financial statements based upon the accounting records.

1.2 Sufficient appropriate audit evidence

HKSA 500.6,
A4-5, A7

HKSA 500 (Clarified) requires that the auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. "Sufficiency" and "appropriateness" are closely linked and apply to both tests of controls and substantive procedures.



Key terms

HKSA
200.13b

Sufficiency is the measure of the **quantity** of audit evidence.

Appropriateness is the measure of the **quality** or **relevance and reliability** of the audit evidence.

How much audit evidence is required depends on the **level of risk** in the area being audited, and the **quality** of evidence which may be obtained. If the evidence is both highly relevant and reliable then it may suffice. The quality of evidence can be measured by various criteria which we cover in the paragraphs below.

1.2.1 Relevance and reliability of audit evidence

Relevance of audit evidence may be affected by the direction of testing and deals with the logical connection with the purpose of the audit procedures or the assertion under consideration.

Reliability of audit evidence is influenced by the source and its nature, and the circumstances under which the audit evidence is obtained. Controls over preparation of the information and the maintenance of the information are relevant.

To be able to form an opinion the auditor must form an opinion as to whether information provided by the entity is **sufficiently reliable** for the auditor's purposes (HKSA 500 (Clarified)). This entails:

- obtaining audit evidence about the accuracy and completeness of the information
- evaluating whether the information is sufficiently accurate and detailed for the auditor's purposes

The following checklist may help in assessing the **reliability** of audit evidence:

Source	Quality of evidence
External	Audit evidence from external sources is more reliable than that obtained from the entity's records because it is from an independent source outside the entity
Auditor	Evidence obtained directly by auditors is more reliable than that obtained indirectly or by inference
Entity	Evidence obtained from the entity's records is more reliable when the related control system operates effectively
Written	Evidence in the form of documents (paper or electronic) or written representations are more reliable than oral representations, since oral representations can be retracted
Originals	Original documents are more reliable than photocopies or facsimiles, which can easily be altered by the entity

Auditors must use **professional judgment** and exercise **professional scepticism** when evaluating the sufficiency and appropriateness of audit evidence to support the audit opinion.

1.2.2 Assessing the appropriateness and sufficiency of different sources of audit evidence

Sources of audit evidence

The auditor can only provide reasonable assurance that the financial statements contain no material misstatements. The auditor can use different sources and methods to obtain audit evidence, including sampling and analytical procedures to form audit opinion.

A particular audit procedure may provide audit evidence that is relevant to a particular assertion. Audit evidence can be collected from internal or external sources, for example:

- Internal sources** of audit evidence include: accounting records, management reports and documents, internal control, assets, management and other employees.
- External sources** of audit evidence include: documents from suppliers, customers, bankers, professionals eg lawyers, surveyors and lenders to the entity.

Performing some audit procedures such as analysing, reviewing, reperforming or reconciling can collect audit evidence and through the performance of such audit procedures, the auditor may determine whether the accounting records are consistent and agree to the financial statements.

Consistent audit evidence, that is obtained from different sources or a different nature, can give more assurance than from items of audit evidence considered individually.

In determining the **sufficiency and sources of evidence** required to support the audit opinion, the auditor normally considers the following:

- (i) Relevance and reliability of information obtained;
- (ii) Materiality of the items being audited;
- (iii) The cost of collection of audit evidence;
- (iv) The consistency of audit evidence obtained from different sources.

Sources of information

The auditor is required to consider whether the collected information from the following sources is also relevant to identifying risks of material misstatement:

- (i) Client acceptance or continuous process;
- (ii) Information obtained from other engagements the engagement partner has performed for the entity;
- (iii) The auditor's previous experience with the entity; and
- (iv) Audit procedures conducted in previous audits.

Auditors should determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.

2 Financial statement assertions



Topic highlights

Audit procedures are designed to obtain evidence about the **financial statement assertions**. Assertions relate to **classes of transactions and events**, **account balances** at the period-end, and **presentation and disclosure**.



Key term

Assertions are 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 misstatement that may occur.

HKSA 315.4

HKSA 315.
A111

The auditor will carry out procedures that are designed to test the assertions made by management. HKSA 315 (Revised) identifies these as follows:

Assertions used by the auditor

<p>Assertions about classes of transactions and events for the period under audit</p>	<p>Occurrence: transactions and events that have been recorded have occurred and pertain to the entity</p> <p>Completeness: all transactions and events that should have been recorded have been recorded</p> <p>Accuracy: amounts and other data relating to recorded transactions and events have been recorded appropriately</p> <p>Cut-off: transactions and events have been recorded in the correct accounting period</p> <p>Classification: transactions and events have been recorded in the proper financial statements</p>
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Assertions used by the auditor

Assertions about account balances at the period-end	<p>Existence: assets, liabilities, and equity interests exist</p> <p>Rights and obligations: the entity holds or controls the rights to assets, and liabilities are the obligations of the entity</p> <p>Completeness: all assets, liabilities and equity interests that should have been recorded have been recorded</p> <p>Valuation and allocation: assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded</p>
Assertions about presentation and disclosure	<p>Occurrence and rights and obligations: disclosed events, transactions and other matters have occurred and pertain to the entity</p> <p>Completeness: all disclosures that should have been included in the financial statements have been included</p> <p>Classification and understandability: financial information is appropriately presented and described, and disclosures are clearly expressed</p> <p>Accuracy and valuation: financial and other information are disclosed fairly and at appropriate amounts</p>

2.1 Audit procedures to obtain audit evidence



Topic highlights

Audit evidence can be obtained by inspection, observation, inquiry and confirmation, recalculation, re-performance and analytical procedures.

HKSA
500.A10-25

The auditor obtains audit evidence by undertaking audit procedures to do the following:

- Obtain an understanding of the entity and its environment to assess the risks of material misstatement, whether due to fraud or misstatement, at the financial statement and assertion levels (**risk assessment procedures**)
- Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (**tests of controls**)
- Detect material misstatements at the assertion level (**substantive procedures**)

The auditor must **always** perform **risk assessment procedures** to provide a satisfactory assessment of risks.

Tests of controls are necessary to test the controls to support the risk assessment, and are used when there is expectation of the operating effectiveness of controls and also when substantive procedures alone do not provide sufficient appropriate audit evidence.

Substantive procedures must **always** be carried out for **material** classes of transactions, account balances and disclosures.

The audit procedures described in the table below can be used as risk assessment procedures, tests of controls and substantive procedures.



HKSA 330.4

Key terms

Tests of controls are designed to evaluate the operating effectiveness of controls preventing, or detecting and correcting, material misstatements at the assertion level.

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level.

They are generally of two types:

- Substantive analytical procedures
- Tests of details of classes of transactions, account balances and disclosures

Auditors obtain evidence by one or more of the following procedures.

Procedures

Inspection of tangible assets	<p>Inspection of tangible assets that are recorded in the accounting records confirms existence, but does not necessarily confirm rights and obligations or valuation.</p> <p>Confirmation that assets seen are recorded in accounting records gives evidence of completeness.</p>
Inspection of documentation or records	<p>This is the examination of documents and records, both internal and external, in paper, electronic or other forms. This procedure provides evidence of varying reliability, depending on the nature, source and effectiveness of controls over production (if internal).</p> <p>Inspection can provide evidence of existence (eg a document constituting a financial instrument), but not necessarily about ownership or value. In addition, inspecting an executed contract may provide audit evidence to the entity's application of accounting policies, such as revenue recognition.</p>
Observation	<p>This involves watching a procedure or process being performed (for example, post opening). It is of limited use, as it only confirms the procedure took place when the auditor was watching, and because the act of being observed could affect how the procedure or process was performed.</p>
Inquiry	<p>This involves seeking information from entity staff or external sources.</p> <p>Strength of evidence depends on the knowledge and integrity of source of information. Inquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level nor is it sufficient to test the operating effectiveness of controls.</p>
Confirmation	<p>This is the process of obtaining a representation of information or of an existing condition directly from a third party eg confirmation from bank of bank balances. Confirmations are used to obtain audit evidence about the absence of certain conditions.</p>
Recalculation	<p>This consists of checking the mathematical accuracy of documents or records and can be performed through the use of IT.</p>
Reperformance	<p>This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.</p>
Analytical procedures	<p>Evaluating and comparing financial and/or non-financial data for plausible relationships. Also include the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.</p>



Self-test question 1

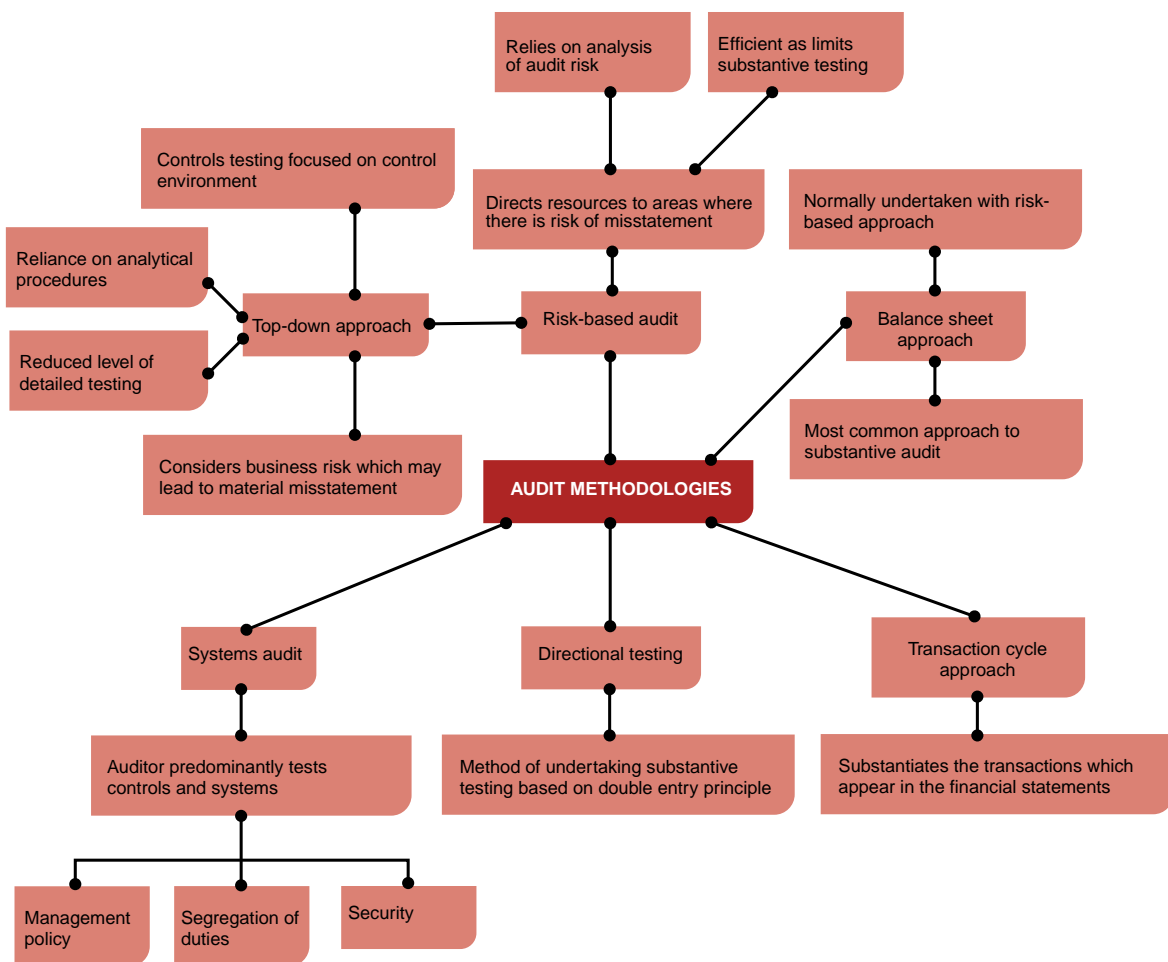
In auditing various accounts, there may be a choice of the types or amounts of evidence available to evaluate management’s assertions. For the following three accounts, describe some high quality forms of evidence that the auditor should obtain.

- (a) The net balance in accounts receivable
- (b) The additions to non-current assets
- (c) The accounts payable

(The answer is at the end of the chapter)

3 Audit methodologies

3.1 Overview



3.2 Risk-based audit



Topic highlights

Risk-based auditing refers to the development of an audit strategy in response to identified risk factors in an entity's business environment. Auditors use judgment to determine what level of risk pertains to different areas of an entity's systems and devise appropriate audit tests which target the most high-risk areas.

Under the risk-based approach audit resources are directed most heavily towards those areas that have been identified as those where a misstatement is most likely to occur. This increases the opportunities for detecting misstatements and avoids excessive time being spent testing areas where the risk is relatively low.

The use of risk-based auditing has grown in response to two main factors:

- (a) Increased **complexity in the business environment** augmenting the danger of fraud or misstatement. Computerised systems where access and intervention by unauthorised personnel are harder to detect, growing internationalisation of business and higher levels of cross-border transactions add to the complexity.
- (b) Auditors are under increased pressure to deliver an improved level of service while keeping fee levels down.

3.3 “Top-down” approach



Topic highlights

With a “**top-down**” approach (sometimes known as the business risk approach) controls testing is targeted at high level controls and the amount of substantive testing is reduced.

HKSA 315 (Revised) (which you studied in Chapter 8) requires that, as part of obtaining an understanding of the entity and its environment, auditors consider the entity's own process for assessing its business and environmental risks, and the potential impact that these might have on the risk of material misstatements in the financial statements.

This “business risk” approach was developed because sometimes the risk of the financial statements being misstated arises predominantly from the business risks of the entity, as discussed in Chapter 8.

Auditors must consider:

- which factors lead to the problems which may cause material misstatements
- how the audit may contribute to the business pursuing its goals

The business risk audit works by repeating the risk management steps used by the directors in running the business. The auditors will **check that the financial statement objectives have been met**, through a wider investigation as to whether the entity has successfully attained its other business objectives and through using the process of analysis as a way of furthering their own understanding about the entity, its management and the environment in which it operates.

This approach has been called a “**top-down**” approach, because it starts with a high level view of the business and its objectives and works back down to the financial statements. It is more traditional to start with the balances themselves and work up.

The procedures used have to be modified accordingly:

Audit procedure	Effect of “top-down” approach
Tests of controls	Controls testing is focused on the control environment and corporate governance rather than the detailed procedural controls tested under traditional approaches
Analytical procedures	Analytical procedures are used more heavily in a business risk approach as they are consistent with the auditor's desire to understand the entity's business rather than to prove the figures in the financial statements
Detailed testing	The combination of the above two factors, particularly the higher use of analytical procedures will result in a lower requirement for detailed testing, although substantive testing will not be eliminated completely

The other advantage of a business risk approach is there is greater opportunity for the auditor to add value to the entity's business and to enhance risk management strategies for the business in the future.

3.3.1 Advantages of top-down approach

There are a **number of reasons** why firms who use the (top-down) approach prefer it to historic approaches:

- (a) Adds more value as the approach focuses on the business as a whole
- (b) Audit attention focused on high level controls and extensive use of analytical procedures increases audit efficiency and therefore reduces cost
- (c) Does not focus on routine processes, which technological developments have rendered less prone to misstatement than has historically been the case
- (d) Responds to the importance that regulators and the government have placed on corporate governance in recent years
- (e) Lower engagement risk (risk of auditor being sued) through broader understanding of the entity's business and practices

3.4 Systems audit versus system-based audit

3.4.1 Systems audit



Topic highlights

An auditor may predominantly test controls and systems, but substantive testing can *never* be eliminated entirely.

As part of any audit, auditors assess the quality and effectiveness of the accounting system. An auditor will focus especially on the system of controls put in place by the directors and ascertain whether they believe it is effective enough for them to be able to rely on it for the purposes of their audit. If they believe that the system is effective, auditors will carry out tests of controls to ensure that the control system operates and, at the same time, auditors will reduce the amount of substantive testing.

Increasingly, auditors must take consideration of computer systems. Auditors may accept an assurance engagement to undertake this task outside of the main audit and to report on their findings.

The following are the key areas on which they are likely to concentrate in order to establish how reliable the systems are:

Factors	Questions asked
Management policy	<ul style="list-style-type: none"> • Does management have a written statement of policy with regard to computer systems? • Is it compatible with management policy in other areas? • Is it adhered to? • Are the policies sufficient and effective? • Is it updated when the systems are updated? • Does it relate to the current system?
Segregation of duties	<ul style="list-style-type: none"> • Is there adequate segregation with regard to data input? • Are there adequate system controls (eg passwords) to enforce segregation of duties?
Security	<ul style="list-style-type: none"> • Is there a security policy in place? This may include physical security such as locked doors, access security such as passwords and data security such as anti-virus software • Is it adhered to? • Is it sufficient and effective?

The system audit file usually contains the auditor's notes and procedures of the internal control and accounting system on an entity. The documentation and the tests of controls performed may be separately filed in a system audit file which is often assembled in the interim visit and updated in the final visit.

3.4.2 System-based audit

System-based auditing is an audit methodology designed to check upon the adequacy and effectiveness of internal controls in both financial and non-financial systems. This audit approach employs a systematic method to identify core problems by examining the system in question to identify the causes of problems and to come up with a fundamental remedy.

For example, a system-based audit would examine the overall financial system without stopping to point out the known problems in order to reach the root cause and recommend how to address the problems. System-based auditing focuses on the most strategic and high risk areas.

3.5 Balance sheet approach



Topic highlights

An auditor may choose predominantly to carry out substantive tests on year end balances.

3.5.1 Balance testing

The balance sheet approach is the **most common approach to the substantive part of the audit**, after controls have been tested.

The statement of financial position (balance sheet) shows a “snapshot” of the financial position of the business at a point in time. It follows that if it is fairly stated and the previous snapshot was fairly stated then it is reasonable to undertake lower level testing on the transactions which connect the two, for example, analytical procedures (examined in Chapter 8).

Therefore under this approach, the auditors seek to concentrate efforts on substantiating the closing position in the year, shown in the statement of financial position, having determined that the closing position from the previous year (also substantiated) has been correctly transferred to be the opening position in the current year.

3.5.2 Relationship with business risk approach

It is stated above that the substantive element of an audit undertaken under a business risk approach is restricted due to the high use of analytical procedures. However, the element of substantive testing which remains in a business risk approach can be undertaken under the balance sheet approach.

In some cases, particularly **small entities**, the business risks may be strongly connected to the fact that management is concentrated in one person. Another feature of small entities may be that their statement of financial position is uncomplicated and contains one or two material items, for example, receivables or inventory.

When this is the case, it is **often more cost-effective to undertake a highly substantive approach than to undertake a business risk assessment**, as it is relatively simple to obtain the assurance required about the financial statements from taking that approach.

3.5.3 Limitations of the balance sheet approach

When not undertaken in conjunction with a risk-based approach or systems testing, the **level of detailed testing** can be high, rendering it **costly**.

3.6 Transaction cycle approach

Cycles testing is in some ways closely linked to systems testing, because it is based on the same systems.

When auditors take a cycles approach, they test the transactions which have occurred, resulting in the entries in the statement of profit or loss and other comprehensive income or statement of financial position (for example, sales transactions, inventory purchases, asset purchases, wages payments, and other expenses).

They would select a sample of transactions and test that each transaction was complete and processed correctly throughout the cycle. In other words, they substantiate the transactions which appear in the financial statements.

3.7 Directional testing



Topic highlights

Directional testing is a method of discovering misstatements and omissions in financial statements.

Directional testing is a method of undertaking detailed substantive testing. Substantive testing seeks to discover misstatements and omissions, and the discovery of these will depend on the direction of the test.

Broadly speaking, substantive procedures can be said to fall into two categories:

- Tests to discover **misstatements** (resulting in over or understatement)
- Tests to discover **omissions** (resulting in understatement)

3.7.1 Tests designed to discover misstatements

These tests will start with the **financial statement records** in which the transactions are recorded and check from the entries to supporting documents or other evidence. Such tests should detect any overstatement and also any understatement through causes other than omission.

3.7.2 Tests designed to discover omissions

These tests must start from **outside the accounting records** and then check back to those records. Understatements through omission will never be revealed by starting with the financial statement itself as there is clearly no chance of selecting items that have been omitted from the financial statement.

3.7.3 Directional testing and double entry

The concept of directional testing derives from the principle of double entry bookkeeping, in that for every **debit** there is a **corresponding credit**, (assuming that the double entry is complete and that the financial statement records balance). Therefore, any **misstatement** of a **debit entry** will result in either a corresponding **misstatement** of a **credit entry** or a **misstatement** in the opposite direction, of **another debit entry**.

By designing audit tests carefully the auditors are able to use this principle in drawing audit conclusions, not only about the debit or credit entries that they have directly tested, but also about the corresponding credit or debit entries that are necessary to balance the books.

So, by performing the primary tests the auditors obtain audit assurance in other audit areas. Successful completion of the primary tests will therefore result in them having tested all financial statement areas both for overstatement and understatement.

The major advantage of the directional audit approach is its cost-effectiveness:

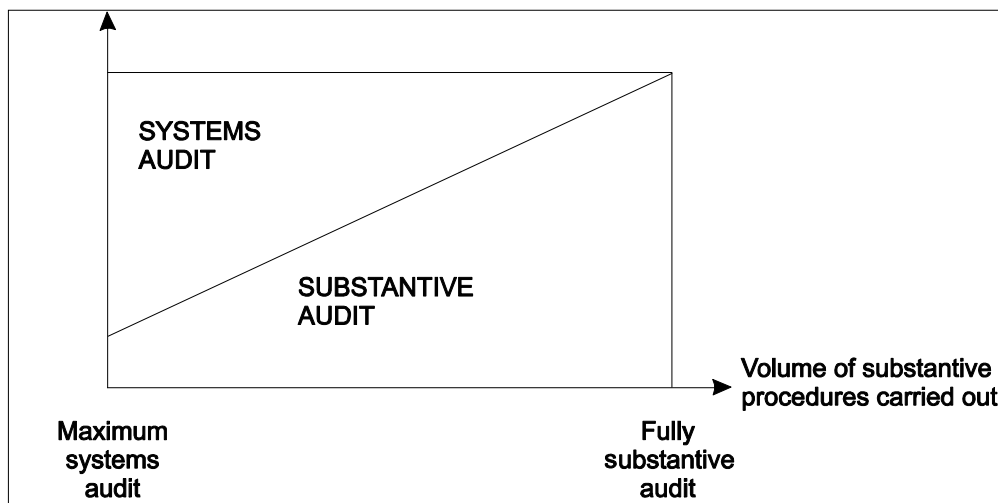
- (a) Assets and expenses are tested for overstatement only, and liabilities and income for understatement only, that is, items are not tested for both overstatement and understatement.
- (b) It audits directly the more likely types of transactional misstatement, ie unrecorded income and improper expense (arising intentionally or unintentionally).

3.8 Cost and performance efficiency of different audit methodologies

As part of the planning process for any audit, the auditor must select the appropriate audit methodology to apply in the audit, in order to deliver the objectives of the audit in the most efficient manner possible. Possible methodologies are:

- risk-based audit
- top-down approach
- systems audit
- balance sheet approach
- transaction cycle approach

Each methodology will incur costs and will offer different levels of efficiency in terms of the hours of work necessary to deliver the audit objectives. Remember that the auditor must decide on the appropriate blend of system testing and substantive procedures, as in the diagram below.



Although an audit can be carried out with 100 % substantive procedures, it is not possible to carry out a 100 % systems audit. There must always be some substantive testing before an audit opinion can be delivered.

We shall look at each of the methodologies in turn.

3.8.1 Risk-based audit

Risk-based audit relies on analysing audit risk into its component parts (inherent risk, control risk and detection risk) and then choosing the appropriate volume of audit procedures to reduce detection risk to the level necessary that audit risk is at the acceptable level.

The analysis of risk must be carried out before detailed audit work commences and will require some hours of the time of an experienced auditor which may be expensive. But, once this analysis has been performed, only a limited number of hours of substantive auditing is required, so this methodology can be efficient.

3.8.2 Top-down approach

The **top-down approach** operates by looking at the business and its objectives and working back down to the financial statements. This needs a detailed understanding of the business and its strategy, requiring highly skilled analysis combined with a minimum of substantive procedures.

It will not be efficient to audit a small company using the top-down approach. Sufficient audit evidence can be gathered more economically using a highly substantive approach. However a top-down approach is likely to be an efficient way of auditing a **large entity**.

3.8.3 Systems audit

A **system audit** concentrates on testing the controls in operation in a business, but as mentioned above there must always be some substantive testing. A systems audit on its own will never produce sufficient evidence to support an audit opinion.

3.8.4 Balance sheet approach

The **balance sheet approach** to auditing concentrates on vouching the carrying amounts of each of the assets and liabilities recognised in the statement of financial position by gathering evidence to support each of the financial statement assertions embodied therein. If the closing net assets are proved to be fairly stated and it is known that the opening net assets are fairly stated, then the transactions linking the two (for example, sales and cost of sales) need only be tested using analytical procedures.

For a small entity, the cost of auditing using the balance sheet approach will be low, since junior auditors can be employed to carry out the work, and there will only be a moderate volume of work to be done. Therefore this is the most efficient methodology for auditing a **small entity**.

For a large entity, the cost of the balance sheet approach will be prohibitive since the number of individual assets and liability balances to be vouched will be large. Therefore, this is not an efficient methodology for auditing a large entity.

3.8.5 Transaction cycle approach

The **transaction cycle approach** tests a sample of transactions to make sure that they are processed correctly throughout each cycle of the business. For example, in the sales cycle transactions can be tested from the first receipt of an order all the way through to despatching the goods and receiving payment.

Once again, this would be prohibitively expensive as an audit approach in a large entity, although it could be used as part of an efficient audit of a small entity.

In every case the auditor must use their professional judgment to decide on a methodology that will generate **sufficient audit evidence** and offer **value for money** to the client at the same time.

3.9 Summary of approaches

Approach	Key feature
Risk-based audit	Directs resources most heavily towards areas where misstatements are most likely to occur.
Top-down approach	Targets controls testing at high level controls and reduces substantive testing.
Systems audit	Focuses on systems of controls and establishing the reliability of the system.
Balance sheet approach	Concentrates efforts on substantiating the closing position at the period end.
Transaction cycle approach	Tests that transactions are complete and correctly processed throughout the specific cycle.
Directional testing	Derives from the principle of double entry bookkeeping that for every debit there is a corresponding credit.

Note.

In many cases the audit approach will involve aspects of more than one of the methods referred to above.

4 Audit sampling



Topic highlights

Auditors usually seek evidence from less than 100 % of items of the balance or transaction being tested by using **sampling techniques**.

HKSA 500.10

HKSA 500 (Clarified) *Audit Evidence* requires that when designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are most effective in meeting the purpose of the audit procedures.

Some testing procedures do *not* involve sampling, such as:

(a) **Testing 100 %** of items in a population

In some circumstances, auditors may decide that it will be appropriate to test the entire population of items. Auditors are unlikely to test 100 % of items when carrying out tests of controls, but 100 % testing may be appropriate for certain substantive procedures. 100 % examination may be appropriate in the following circumstances:

- (i) If the population is made up of a **small number of high value items**;
- (ii) There is a **significant high risk** of material misstatement and other means do not provide sufficient appropriate audit evidence, then 100 % examination may be appropriate; or
- (iii) The repetitive nature of a calculation or other process **performed automatically by an information system** makes a 100 % examination more effective.

(b) **Testing specific items**

The auditor may alternatively select certain items from a population because of specific characteristics they possess. The selection is based on auditor's judgment. The results of items selected in this way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population. Specific items tested may include the following:

- (i) **High value or key items.** The auditor may select high value items or items that are suspicious, unusual or prone to misstatement;
- (ii) **All items over a certain amount.** Selecting items this way may mean a large proportion of the population can be verified by testing a few items;
- (iii) **Items to obtain information** about the entity's business, the nature of transactions, or the entity's accounting and control systems; and
- (iv) **Items to test procedures**, to see whether particular procedures are being performed.

Testing specific items does not provide audit evidence concerning the remainder of the population.

4.1 Introduction to audit sampling

HKSA
530.4-5

Auditors are required to carry out audits efficiently, cost effectively and within time constraints. Audit sampling offers innumerable benefits in achieving this and is common practice on most audits. HKSA 530 (Clarified) *Audit Sampling* states that "the objective of the auditor, when using audit sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected."



Key terms

HKSA
530.5a, b, g

Audit sampling involves the application of audit procedures to less than 100 % of the items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Population is the entire set of data from which a sample is selected and about which an auditor wishes to draw conclusions.

Statistical sampling is any approach to sampling that involves random selection of a sample, and the use of probability theory to evaluate sample results, including measurement of sampling risk.

Non-statistical sampling is the approach to sampling where the auditor does not use statistical methods and draws a judgmental opinion about the population.

4.2 Design of the sample

4.2.1 Suitable for the purpose

HKSA 530.6

HKSA 530 (Clarified) requires an auditor to consider the following when designing an audit sample:

(a) Consider the **purpose of the audit procedure**

Auditors must consider:

- (i) the specific **audit objectives** and the **audit procedures** which are most likely to achieve them
- (ii) the nature and characteristics of the **audit evidence** sought, possible deviation or misstatement conditions and the **rate of expected deviation or misstatements**.

This will help them to define what constitutes a misstatement or deviation and what population to use for sampling.

(b) Consider the **characteristics of the population** from which the sample will be drawn:

- (i) For **tests of controls**, the auditor should make an estimate of the expected rate of deviation based on expectation through investigation of the relevant controls or on the examination of a small number of items from the population. If the expected rate of deviation is above a certain level, the auditor will normally reject further tests of controls.
- (ii) For **tests of details**, the auditor may decide to test a large sample size or test 100 % if the expected misstatement is high.

4.2.2 Drawn from a well defined population

To be representative the population from which the sample is drawn must be defined suitably for the specific audit objectives. The auditor needs to define the characteristic that he wishes to test in order to limit the total population. How he defines them may depend on whether he is seeking to test for overstatement or understatement and what he believes he may detect.

The population may be divided into sampling units in many different ways. For example, for receivables it may be an individual receivables balance or, in monetary unit sampling, \$1 of the total receivables balance. Auditors must define the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.



Key term

Sampling units are the individual items constituting a population.

HKSA 530.5f

HKSA 530 (Clarified) requires that the auditor “shall select items for the sample in such a way that each sampling unit in the population has a chance of selection”. This requires that **all items** in the population have an opportunity of being selected.

There are five selection methods available:

Random selection	Ensures that all items in the population have an equal chance of selection, eg by use of random number tables or computerised generator.
Systematic selection	The number of sampling units in the population is divided by the sample size to give a sampling interval. The auditor will need to determine the sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.
Haphazard selection	The auditors selects the sample without following a structured technique, avoiding any conscious bias or predictability and thus attempting to ensure that all items in the population have a chance of selection. This method is not appropriate when using statistical sampling.
Sequence or block selection	This involves selection of blocks of items from within the population. Block selection cannot ordinarily be used in audit sampling as most populations are structured. The technique is rarely an appropriate sample selection technique when the auditor intends to draw valid inferences about the entire population based on the sample.
Monetary Unit Sampling (MUS) (Value-weighted sampling)	The sample size, selection and evaluation results are in conclusion in monetary amounts. The auditor would direct his effort to the larger value items because they have a greater chance of selection as compared to smaller sample sizes.



Key terms

Stratification is the process of dividing a population into subpopulations, each of which is a group of sampling units, which have similar characteristics (often in monetary value).

Each sampling unit can only belong to one, specifically designed stratum, therefore reducing the variability within each stratum. This enables the auditors to direct audit effort towards items which, for example, contain the greatest potential monetary misstatement. Ways of dividing items into strata include by age or by amount.

4.3 Sample size and risk

HKSA 530.7,
A10-11

HKSA 530 (Clarified) requires that the auditor “must determine a sample size sufficient to reduce sampling risk to an acceptably low level”. While inevitable and beneficial in many ways, the use of sampling introduces an element of sampling risk. This is the risk is that the auditor’s conclusion is skewed by the particular data selected and that a different outcome may have been reached had the whole population been subject to the audit procedure. Ultimately, this could lead to an assessment that a particular system of control is effective, when in fact it is not; or conversely, that a system is not effective, when in fact, it is. The auditor must use professional judgment to assess this risk and apply procedures to ensure it is reduced to an acceptably low level.



Key terms

HKSA 530.5c

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

HKSA 530.5d

Non-sampling risk is the risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk.

Sampling risk can lead to two types of erroneous conclusions:

Tests of controls	<ul style="list-style-type: none"> • Controls are more effective than they actually are (1) • Controls are less effective than they actually are (2)
Tests of details	<ul style="list-style-type: none"> • Material misstatement does not exist when in fact it does (1) • Material misstatement exists when in fact it does not (2)

- (1) Auditors are most concerned with this type of erroneous conclusion as it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (2) These types of erroneous conclusion affect audit efficiency as it would lead to additional work.

Sampling risk may be reduced by increasing the sample size for both tests of control and substantive procedures while non-sampling risk, may be reduced by effective engagement planning, supervision and review.

How much sampling risk an auditor will tolerate depends on the degree of reliance on the results of the procedure in question. Larger sample sizes generate lower risks and a higher degree of tolerance.

When designing a sample, the auditor also determines tolerable rate of deviation and tolerable misstatement for the subsequent evaluation of the results.

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, most audit evidence is persuasive rather than conclusive, the auditor might use inappropriate procedures or the auditor might misinterpret evidence or fail to recognise a misstatement or deviation.

4.4 Performing audit procedures on items selected

HKSA 530.9-11

HKSA 530 (Clarified) requires that the auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the audit procedure is not applicable to the selected item, the auditor is required to perform the procedure on a replacement item.

4.4.1 Unable to apply the designed audit procedures

If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures to a selected item, the auditor is required to treat that item as a deviation from the prescribed control in the case of tests of controls; or misstatement in the case of tests of details.

4.5 Deviation or misstatements

HKSA 530.12

Based on the sampling results, HKSA 530 (Clarified) requires the auditor to:

- investigate the nature and cause of any deviation or misstatements identified; and
- evaluate their possible effect on the purpose of the audit procedure and on other areas of audit.

4.5.1 Possibility of fraud

In analysing the deviations and misstatements identified, the auditor may observe that many have a common feature ie type of transactions, location, period of time.

The auditor may decide to identify all items in the population that possess the common feature in such circumstances, and extend audit procedures to those items.

Such deviations or misstatements may be intentional and may indicate the **possibility of fraud**.

4.5.2 Anomaly



Key term

HKSA 530.5e

Anomaly is defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

In the extremely rare circumstances, when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall perform additional procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population. However, for anomalies, projecting misstatements to the population is not required.

HKSA 530.14

4.6 Projecting misstatements

- (a) For tests of details HKSA 530 (Clarified) requires the auditor to project misstatements found in the sample to the population in order to obtain a broad view of the scale of misstatement and its effect.

Any unexpectedly high misstatement amount in a sample may cause the auditor to believe material misstatements exist in a class of transactions or account balance; and

- (b) For tests of controls, no projection of deviations is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.

However if deviations in the way the controls are applied by the entity are identified, the auditor should consider the direct effect of the identified deviations, what they reveal about the effectiveness of internal controls and their effect on the audit approach, as significant deviations will affect the amount of substantive procedures needed. An unexpectedly high sample deviation rate may lead to an increase in the assessed risk of material misstatement.

4.7 Evaluation of sample results

4.7.1 Analysis of misstatements in the sample

HKSA 530.15

HKSA 530 (Clarified) requires the auditor to evaluate:

- (a) the results of the sample; and
- (b) whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.

The tolerable rate of deviation and tolerable misstatement determined during the design of the audit sampling can be used in the evaluation of the sample results.



Key terms

HKSA 530.5j

Tolerable rate of deviation is the rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

HKSA 530.5i

Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

The auditor may perform the following procedures when he concludes that audit sampling has not provided a reasonable basis for conclusions about the population tested:

- (a) Request management to investigate identified misstatements, potential misstatements and to make necessary adjustments
- (b) Modify nature, extent and timing of further audit procedures to achieve desired assurance.

When determining whether the sample provides a reasonable basis for the conclusions about the population as a whole, the auditor should first set a level of tolerable misstatement. If when the results of the test sample are projected for the population as a whole, and any anomalous results taken into account, this level is exceeded, then the sample must be considered as not providing a reasonable basis for conclusions about the population as a whole.

4.7.2 Projection of misstatements

For **tests of details**, the auditor should **project** monetary misstatements found in the sample to the population, and should consider the **effect** of the projected misstatements on the audit objective being tested and on other areas of the audit. The projected misstatements should be compared to the **tolerable misstatement**.



Self-test question 2

Consider each of the following independent situations:

- (a) The auditor used non-statistical (judgmental) sampling techniques to determine an appropriate sample size of 20 in testing the proper authorisation of purchases. After randomly selecting 20 purchase transactions, the auditor performed appropriate testing and found that three of the 20 transactions were not properly authorised.
- (b) The auditor used attribute sampling techniques to test a key authorisation control. For a 5 % risk of over reliance, a tolerable deviation rate of 10 % and an expected population deviation rate of zero, the auditor determined the minimum sample size to be 29. The auditor selected 29 items using a systematic sampling technique, and found that one transaction was not properly authorised.

Required

For each of the scenarios, (a) and (b), discuss the relevant issues in determining whether the auditor can place reliance on the key control.

(The answer is at the end of the chapter)

5 Audit documentation



Topic highlights

It is important to document audit work performed in working papers to:

- enable reporting partner to ensure all planned work has been completed adequately;
- provide details of work done for future reference;
- assist in planning and control of future audits; and
- encourage a methodical approach.

5.1 Requirement of audit documentation



Key term

HKSA 230.6a

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained and conclusions reached. The terms “working papers” or “work papers” are also sometimes used.

HKSA 230.5,
7, 8

In accordance with HKSA 230 (Clarified) *Audit Documentation*, the auditor prepares, on a timely basis, audit documentation that provides:

- (a) a sufficient and appropriate record of the basis for the auditor's report; and
- (b) evidence that the audit was planned and performed in accordance with HKSAs and applicable legal and regulatory requirements.

HKSA 230 (Clarified) requires that the auditor shall prepare audit documentation on a **timely basis** in order to enhance the quality of the audit and to improve the review and evaluation process of the audit evidence obtained and conclusions reached before the auditor's report is finalised.

5.1.1 Nature, form, content and extent of audit procedures performed

HKSA 230 (Clarified) requires working papers to be sufficiently complete and detailed to provide an overall understanding of the audit to an independent third party who had not been involved. Auditors are not expected to record everything they consider. Therefore, judgment must be used as to the extent of working papers, based on the following general rules.



Key term

HKSA 230.6c

An **experienced auditor** refers to an individual who has practical audit experience and a reasonable understanding of the audit processes, HKSAs and applicable legal and regulatory requirements, the business environment in which the entity operates and the auditing and financial reporting issues relevant to the entity's industry.

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor having no previous connection with the audit, to understand:

- (a) the nature, extent and timing of the audit procedures
- (b) the results of the audit procedures performed; and
- (c) significant matters arising during the audit ie significant risks or difficulties in applying audit procedures (See Section 5.6)

The form and content of working papers are affected by matters such as:

- (a) the **size and complexity** of the entity;
- (b) the nature of the audit procedures to be performed;
- (c) the **identified risks** of material misstatement;
- (d) the **significance** of the audit evidence obtained;
- (e) the nature and extent of **exceptions** identified;
- (f) the need to document a **conclusion** or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
- (g) the audit **methodology and tools** used.

5.1.2 Examples of working papers

Work at different stages in audit	Information to be put in working file
Audit planning	<ul style="list-style-type: none"> Evidence of the planning process including audit programmes and any changes thereto
Understanding the entity and its environment	<p>Information obtained in understanding the entity and its environment, including its internal control, such as the following:</p> <ul style="list-style-type: none"> Information concerning the legal documents, agreements and minutes Extracts or copies of important legal documents, agreements and minutes Information concerning the industry, economic environment and legislative environment within which the entity operates Extracts from the entity's internal control manual
Evidence gathering	<ul style="list-style-type: none"> Analyses of transactions and balances Analyses of significant ratios and trends Identified and assessed risks of material misstatements A record of the nature, timing, extent and results of audit procedures Evidence that the work performed was supervised and reviewed An indication as to who performed the audit procedures and when they were performed
Communication with internal and external parties	<ul style="list-style-type: none"> Evidence of the auditor's consideration of the work of internal audit and conclusions reached Copies of communications with other auditors, experts and other third parties Copies of letters or notes concerning audit matters communicated or discussed with management or those charged with governance, including the terms of the engagement and material weaknesses in internal control Details of audit procedures applied regarding components whose financial statements are audited by another auditor Letters of representation received from the entity Notes of discussions about significant matters with management and others
Final stage of audit	<ul style="list-style-type: none"> Conclusions reached by the auditor concerning significant aspects of the audit, including how exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated Copies of the financial statements and audit reports In exceptional circumstances, the reasons for departing from a basic principle or essential procedure of an HKSA and how the alternative procedures performed achieve the audit objective.

5.2 Reasons for audit documentation

Audit documentation is necessary for the following reasons:

- (a) It provides evidence of the auditor's basis for a conclusion including the assumptions behind any judgments used.
- (b) It demonstrates that the audit was conducted in accordance with HKSAs, HKFRSs and any other legal and regulatory requirements.
- (c) It records the plan and performance of the audit.
- (d) It acts as a tool to team members responsible for supervision to direct, supervise and review audit work as it is carried out.
- (e) It enables the team to be accountable for its work.
- (f) It allows a record of matters of continuing significance to be retained.
- (g) It enables the conduct of quality control reviews and inspections (whether internal or external).

5.3 Audit files

Working paper files may be classified into the following categories depending on whether their contents are of ongoing importance or whether they relate to the current reporting period only.



Key term

An **audit file** is one or more folders or other storage media in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

HKSA 230.6b

Audit files: working papers

Permanent audit files (containing information of **continuing importance** to the audit)

- Engagement letters
- New client questionnaire
- The memorandum and articles of association
- Other legal documents such as prospectuses, leases, sales agreements
- Details of the history of the entity's business
- Board minutes of continuing relevance
- Previous years' signed financial statements, analytical review and management letters
- Accounting systems notes, previous years' control questionnaires

Current audit files (containing information of relevance to the **current year's audit**).

These should be compiled on a timely basis after the completion of the audit and should contain:

- Financial statements
- Financial statements checklists
- Management accounts details
- Reconciliations of management accounts and financial statements
- A summary of unadjusted misstatements
- Report to partner including details of significant events and misstatements

-
- Review notes (retain until archive)
 - Audit planning memorandum
 - Time budgets and summaries
 - Representation letter
 - Management letter
 - Notes of board minutes
 - Communications with third parties such as experts or other auditors
-

The working paper files should also contain information covering each audit area. These should include the following:

- A lead schedule including details of the figures to be included in the financial statements
- Problems encountered and conclusions drawn
- Audit programmes
- Risk assessments
- Sampling plans
- Analytical procedures
- Details of substantive tests and tests of controls

If it later becomes necessary to add to or modify the documentation after it has been assembled, then the following should be noted:

- Who made the changes, when they were made, and by whom they were reviewed
- The reasons behind the change
- Whether there was any effect on the auditors' conclusions

Changes are made to an audit file after the audit report has been signed, only in exceptional circumstances. The following should be recorded:

- The circumstances
- The audit procedures performed, evidence obtained, conclusions drawn
- When and by whom changes to audit documents were made and reviewed

5.4 Standardised and automated working papers

The use of **standardised** working papers, for example, checklists and specimen letters, may improve the efficiency of audit work but they can be dangerous because they may lead to auditors mechanically following an approach without using audit judgment.

Automated working paper packages have been developed which can make the documenting of audit work much easier. Such programs aid preparation of working papers, lead schedules, the trial balance and the financial statements themselves. These are automatically cross-referenced, adjusted and balanced by the computer.

The **advantages** of automated working papers are as follows:

- (a) The risk of misstatements is reduced
- (b) The working papers will be neater and easier to review
- (c) The time saved will be substantial as adjustments can be made easily to all working papers, including those summarising the key analytical information
- (d) Standard forms do not have to be carried to audit locations
- (e) Audit working papers can be transmitted for review via email or fax facilities

5.5 Safe custody and retention of working papers

Judgment may have to be used in deciding the length of holding working papers, and further consideration should be given to the matter before their destruction. Working papers are the property of the auditors. They are not a substitute for, nor part of, the entity's accounting records.

Auditors must follow ethical guidance on the confidentiality of audit working papers. They may, at their discretion, release parts of or whole working papers to the entity, as long as disclosure does not undermine "the independence or validity of the audit process". Information should not be made available to third parties without the permission of the entity.

After assembling the papers, the auditor should not delete or discard audit documentation of any nature before the end of its retention period, which is no shorter than five years from the date of the auditor's report, in accordance with HKSQC1 (Clarified).

In exceptional cases, where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor is required to document:

- the specific reasons for making them; and
- when and by whom they were made and reviewed

5.6 Significant matters

HKSA 230.A8

The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit. Examples of significant matters include the following:

- (a) Matters that give rise to significant risks;
- (b) Results of audit procedures relating to the revision of auditor's assessment of the risks of material misstatement and the auditor's responses to those risks;
- (c) Results of audit procedures indicating the financial statements could be material misstated;
- (d) Difficulties auditor faced in applying necessary audit procedures;
- (e) Findings causing modification to the audit opinion or the addition of an emphasis of matter paragraph;
- (f) Discussion of significant matters to any party; and
- (g) How the auditor addressed the inconsistency when information is inconsistent with auditor's conclusion of the significant matter.

5.7 Assembly of the final audit file

HKSA
230.14-16

HKSQC1 (Clarified) requires firms to establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalised. For audit engagements, a time limit would ordinarily not be more than 60 days after the date of the auditor's report.

The auditor should maintain confidentiality, safe custody, integrity, accessibility and retrievability of the audit documentation.

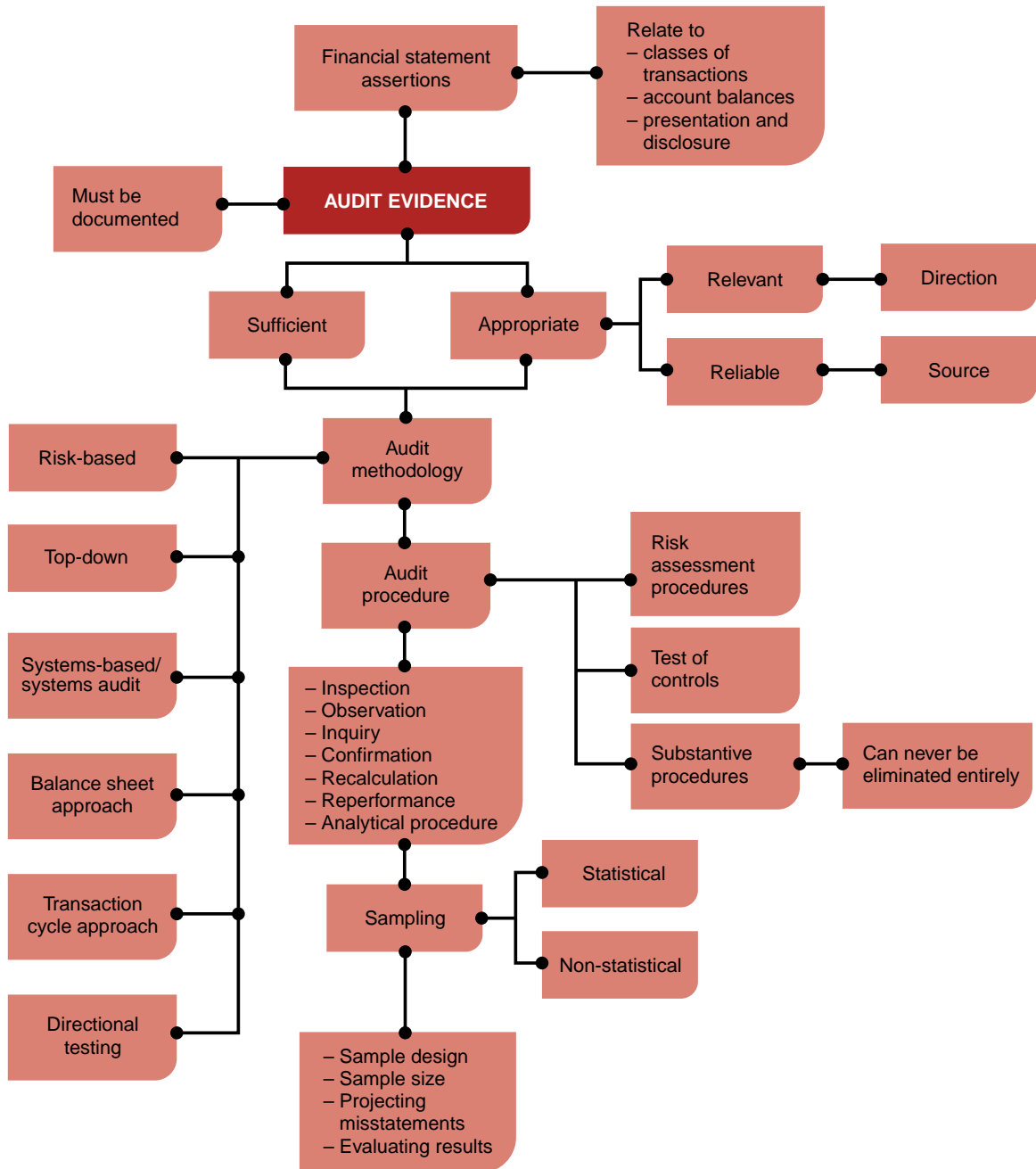
5.8 Changes to audit documentation in exceptional circumstances after the date of the auditor's report

HKSA 230.13

If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:

- the circumstances encountered;
- the new or additional audit procedures performed;
- when and by whom the resulting changes to audit documentation were made and reviewed; and
- the specific reasons for making them.

Topic recap



Answers to self-test questions

Answer 1

- (a) The balance of gross accounts receivable can best be assessed by the use of a receivables circularisation. The allowance for doubtful accounts would be assessed by reviewing management's credit policies, ageing the accounts receivable, examining credit reports or financial statements for major companies, and verifying subsequent remittances. Analytical procedures would also be used.
- (b) The additions to the non-current asset account can best be verified by an examination of the client's capitalisation policies and an examination of both the schedule of additions to non-current assets, and a review of the repairs and maintenance expense account to ensure that no items that should be capitalised are included as expenses. Any rental or lease agreement should also be reviewed to ensure that nothing that should be capitalised has been expensed.
- (c) The accounts payable can be examined by the use of confirmation to test balances, or by a reconciliation with suppliers' statements.

Answer 2

- (a) In determining reliance on this key control, the auditor has used non-statistical sampling. Therefore, the decision as to whether or not the auditor would place reliance on this key control without the undertaking of any further work depends on the auditor's expectations. Such a high deviation rate would be unusual for accepting the control as operating effectively, unless further audit evidence substantiating the initial assessment is obtained.
- (b) The auditor has sampled the minimum size for zero expected deviations from the control condition. As soon as one deviation is identified, as has occurred in this case, the auditor cannot rely on the key control.

Exam practice

**DEF Ltd****10 minutes**

DEF Ltd has a head office and sells footwear accessories through twenty retail outlets in Hong Kong. All cash receipts in the form of cash and credit cards are recorded in the cash till of each outlet. A cash float in the range of \$8,000 to \$15,000 is maintained at each outlet to provide change for the till and cover various routine expenses. All cash takings for the previous day are banked at the beginning of each working day. Cash till reconciliation is performed by a sales assistant and is further reviewed by the shop supervisor at the end of each working day. The reconciliation and the relevant supporting documents are sent to the accounts department daily for further processing.

A & B have been the auditors of DEF Ltd for a number of years. During the current year's audit of DEF Ltd, A & B have reviewed the internal controls on cash in hand and performed all tests of controls they considered necessary.

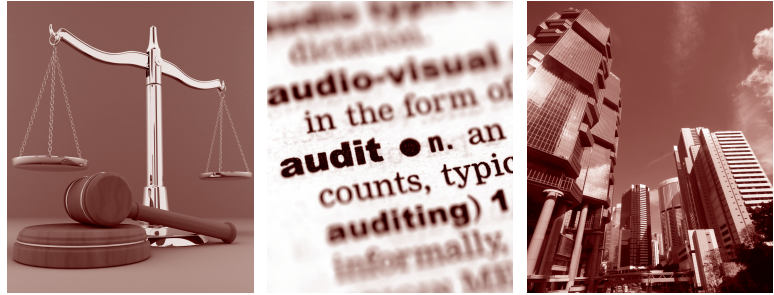
In addition, DEF Ltd has received a bank loan (\$10,000,000 repayable over four years) in order to expand the business during the year. A & B have reviewed the internal controls on the bank loan and have found that it would be more efficient to rely solely on substantive audit procedures.

Required

In the context of A & B's audit of DEF Ltd,

- (a) Explain the difference between sampling risks and non-sampling risks; **(3 marks)**
- (b) Explain how stratification may help to increase the effectiveness of substantive audit procedures. **(3 marks)**

(Total = 6 marks)**HKICPA September 2006 (amended)**



chapter 10

Fraud and irregularities

Topic list

1 Fraud

- 1.1 What is fraud?
- 1.2 Characteristics of fraud
- 1.3 Fraud and the auditor
- 1.4 Risk assessment
- 1.5 Overall responses to assessed risks of material misstatement due to fraud at the financial statement level
- 1.6 Fraud risk factors
- 1.7 Misstatements indicating suspected fraud
- 1.8 Overall responses to assessed risks of material misstatement due to fraud at the assertion level
- 1.9 Analytical procedures performed near the end of the audit
- 1.10 Unable to continue the engagement
- 1.11 Written representations
- 1.12 Communication to management and those charged with governance
- 1.13 Documentation

2 Laws and regulations

- 2.1 Legal requirements relating to an entity
- 2.2 Responsibility of management and those charged with governance
- 2.3 Responsibility of the auditor
- 2.4 Indications of non-compliance with laws and regulations
- 2.5 Audit procedures when non-compliance is identified or suspected
- 2.6 Communicating/reporting identified or suspected non-compliance

3 Following up illegal acts or fraud during the audit

- 3.1 HKSA 240 (Clarified)
- 3.2 HKSA 250 (Clarified)
- 3.3 Money laundering

Learning focus

The extent of auditors' responsibilities in relation to fraud and error is a critical element of the public's perception of the auditor's role. The requirements of HKSA 240 (Clarified) in this regard are core knowledge for this chapter and may have to be applied in practical scenarios.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.05	Planning and risk assessment	3
2.05.08	Explain the effect of fraud and misstatements on audit planning and work	
2.05.09	Explain the effect of laws and regulations, and non-compliance therewith, on audit planning and procedures	
2.12	Completion procedures	
2.12.04	Explain the follow up on illegal act or fraud found while performing an audit especially in the case of money laundering or corruption	3

1 Fraud



Topic highlights

When carrying out risk assessment procedures, the auditor shall also consider the risk of fraud or non-compliance with laws and regulations causing a misstatement in financial statements.

1.1 What is fraud?



Key term

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.

HKSA
240.11a

HKSA 240.3

Fraud may be perpetrated by an individual, or colluded in, with people internal or external to the business. When management or those charged with governance are involved in fraud, it is called **management fraud**. When employees are involved it is called **employee fraud**.

Specifically, there are two types of fraud causing material misstatements in financial statements:

- Fraudulent financial reporting; and
- Misappropriation of assets

1.1.1 Fraudulent financial reporting



Key term

Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

HKSA 240.
A2

Management may intend to influence financial statement users' perceptions as to the entity's performance and profitability.

This may include the following:

- Omission of amounts or disclosures in the financial statements
- Improper disclosure eg deception such as manipulation, falsification, alteration of accounting records
- Intentional misapplication of accounting principles eg delay in recognition
- Concealing important information
- Engaging in complex transactions, leading to inability to collect audit trail
- Recording fictitious journal entries
- Improper use of assumptions or estimates in financial reporting
- Intentionally to reduce earnings for tax planning
- Manipulation, falsification or alteration of accounting records or other documentations

Such fraud may be due to pressure and incentives and may arise due to **management overriding controls** and by aggressive earnings management in order to maximise bonuses. Companies

about to list may contain higher risk in this area due to pressure to meet market expectations or a desire to maximise compensation based on performance. The auditor should be aware if there are matters like unsuitable revenue recognition, inappropriate accruals, liabilities, provisions and reserves accounting or large number of immaterial breaches of financial reporting requirements. Material misstatements due to fraudulent financial reporting are often due to revenue recognition and this is **significant risk**.

1.1.2 Misappropriation of assets



Key term

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts.

HKSA 240.A5

Misappropriation of assets is often perpetrated by single employees in relatively small amounts, although aggregated this amount may become material. However, misappropriation may also involve collusion among a group of employees or management which often makes it more difficult to detect. Collusion or management involvement often makes it easier to create false records to conceal the fraudulent activity.

Misappropriation of assets is a serious threat to an entity. Even when it involves minor pilfering of stock or cash by employees. It indicates an environment of weak internal control and possibly poor relationships between senior management and employees. However, management may be equally guilty and often have a greater opportunity for exploiting weaknesses in the control systems to conceal their fraudulent activities. These activities can take the following forms:

- (a) Embezzling receipts (for example, diverting them to private bank accounts)
- (b) Wrongfully taking possession of physical non-current assets or intellectual property either for personal use or to sell on (for example, stealing stock, or selling data)
- (c) Creating false ledger or payroll entries to cause an entity to pay for goods which have not been ordered or received (payments to fictitious suppliers or employees)
- (d) Using an entity's assets as collateral for a personal loan or loan to a related party

1.2 Characteristics of fraud

HKSA 240.2

Fraud involves:

- (a) **incentive or pressure to commit fraud** – this may mean management is under pressure to achieve unfeasible earnings or may indicate personal financial difficulties
- (b) **an opportunity** – this may be the presence of large amounts of cash or inventory and the ability to override an internal control without detection
- (c) **rationalisation of committing a fraudulent act** – individuals may possess an attitude or character that allow them knowingly and intentionally to commit a dishonest act. Poor management-employee relations may create an attitude of disregard for internal controls.

1.3 Fraud and the auditor

HKSA 240.4,
5

HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* provides guidance to auditors in this area.

1.3.1 Responsibilities of management

The primary responsibility for the prevention and detection of fraud is with both those charged with governance and the management of an entity. It is important that management and those charged with governance place a strong emphasis on **fraud prevention** and **fraud deterrence**.

This is effected by a commitment to a **culture of honesty, ethical behaviour and active oversight** by those charged with governance.

Management can:

- (a) implement and operate an adequate accounting and internal control system to reduce the possibility of fraud and error
- (b) acts in stewardship with regard to the property entrusted to them by shareholders (contractual duty of care)
- (c) develop a code of conduct
- (d) establish an internal audit department
- (e) set up an audit committee

1.3.2 Responsibilities of auditors

An auditor conducting an audit is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

When planning or performing audit procedures or evaluating and reporting on results, in order to reduce the audit risks to an acceptably low level, the auditor should consider the **risks of material misstatements in the financial statements due to fraud and error. (This is mandatory!)** The risk of not detecting material misstatements from fraud is higher than the risk of not detecting a material misstatement due to error.

Auditors should:

- obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud.
- respond appropriately to fraud or suspected fraud identified during the audit.
- **maintain an attitude of professional scepticism** throughout the audit, recognising the possibility that material misstatements due to fraud could exist, considering the honesty and integrity of management and those charged with governance.
- evaluate the design of the entity's related controls, including relevant control activities and determine whether they have been **implemented**.

The auditor cannot be held responsible for the prevention of fraud and error and the risk of not detecting a material misstatement. The risk is greater for frauds that are due to **sophisticated and organised schemes designed to conceal it** such as intentional misrepresentations made to the auditors or deliberate failure to record transactions.

Although the auditor may suspect or identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

HKSA
240.15-18,
25-26, 31

1.4 Risk assessment

HKSA 240 (Clarified) requires a **discussion** among the team members that places particular emphasis on how and where the financial statements may be susceptible to fraud.

1.4.1 Risk assessment procedures

Risk assessment procedures to obtain information in identifying the risks of material misstatement due to fraud shall include the following:

- (a) **Inquiries of management** regarding:
 - (i) **management's assessment** of the risk that the financial statements may be materially misstated due to fraud
 - (ii) **management's process** for identifying and responding to the risks of fraud
 - (iii) **management's communication to those charged with governance** in respect of its process for identifying and responding to the risk of fraud
 - (iv) **management's communication to employees** regarding its views on business practices and ethical behaviour
 - (v) **knowledge** of any actual, suspected or alleged fraud
- (b) **Inquiries of internal audit** for knowledge of any actual, suspected or alleged fraud, and its views on the risks of fraud.
- (c) Obtaining an **understanding** of how those charged with governance **oversee** management's processes for identifying and responding to the risk of fraud and the internal control established to mitigate these risks.
- (d) **Inquiries of those charged with governance** for knowledge of any actual, suspected or alleged fraud and seek views on the adequacy of accounting system, management's process for identifying risks of fraud and internal control.
- (e) Evaluating whether any unusual or unexpected relationships have been identified in performing **analytical procedures** that may indicate risk of material misstatement due to fraud.
- (f) Considering whether any **other information** may indicate risk of material misstatement due to fraud such as information obtained from the auditor's entity acceptance and retention processes, and experience gained on other engagements performed for the entity.
- (g) Evaluating whether any **fraud risk factors** are present.

1.4.2 Identification and assessment of the risk of material misstatement due to fraud

As required by HKSA 240 (Clarified), and in accordance with HKSA 315 (Revised), the auditor shall identify and assess the risks of material misstatement due to fraud

- at the financial statement level; and
- at the assertion level for classes of transactions, account balances and disclosures.

These risks shall be treated as **significant risks**.

The auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks.

1.4.3 Presumed risk of fraud in revenue recognition

Material misstatement due to fraudulent financial reporting relating to revenue recognition may result in both overstatement or understatement of revenue, for example:

- recording fictitious revenue
- using aggressive revenue recognition
- improperly delaying recognition of revenue.

Therefore, HKSA 240 (Clarified) requires the auditor, based on a presumption that there are risks of fraud in revenue recognition, to evaluate which types of revenue, revenue transactions or assertions give rise to such risks.

Those entities such as listed entities that may have pressures or incentives on management to commit fraudulent financial reporting, may face **greater** risks of fraud in revenue recognition.

The auditor shall **document** the reasons for concluding that there is no presumption that there are risks of fraud in revenue recognition.

1.4.4 Presumed risk of control override

Management is in a unique position to perpetrate fraud because of its ability to override controls. Because this risk is present in all entities and is therefore presumed HKSA 240 (Clarified) requires that, irrespective of the auditor's assessment of the risks of management override of controls, the auditor must design and perform audit procedures to respond to this risk.

The following are examples of audit procedures:

- (a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements by:
 - (i) inquiring of individuals responsible for financial reporting process
 - (ii) testing collected journal entries and other adjustments made at the end of the period.
- (b) Review accounting estimates for bias and evaluate whether the circumstances producing the bias represents a risk of material misstatement due to fraud.
 - (i) If there is an indication of a possible management bias the auditor shall re-evaluate the accounting estimate taken as a whole
 - (ii) Perform a retrospective review of management judgments and assumptions relating to significant accounting estimates reflected in the financial statements of the prior year.
- (c) For significant transactions that are outside the normal course of business for the entity, the auditor shall evaluate whether the business rationale of the transactions suggests fraud.

The auditor should consider:

- (i) whether the transactions are complex
- (ii) whether management has discussed the accounting treatment with those charged with governance
- (iii) management placing more emphasis on the need for a particular accounting treatment
- (iv) non-consolidated related parties that are not properly authorised
- (v) unidentified related parties and the related transactions

1.5 Overall responses to assessed risks of material misstatement due to fraud at the financial statement level

HKSA 240.32

In accordance with HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks*, the auditor must determine **overall responses** to address the assessed risks of material misstatement due to fraud at the financial statement level. In this regard, the auditor must:

- (a) **assign and supervise** staff responsible taking into account their knowledge, skill and ability ie individuals with specialised skill and knowledge;
- (b) **increase professional scepticism** ie increase sensitivity in the selection of nature and extent of documentation for material transactions and increase recognition of the need for management explanations or representations for material matters;
- (c) evaluate whether the **accounting policies** may be indicative of fraudulent financial reporting; and
- (d) incorporate **unpredictability** in the selection of the nature, timing and extent of audit procedures to be performed ie adjusting the timing of audit procedures or using different sampling methods.

As we mentioned above, management fraud is more difficult to detect than employee fraud because of management's ability to override controls and therefore manipulate accounting records. HKSA 240 (Clarified) states that when auditor has to respond to the risk of management override of controls, it is mandatory to perform procedures to:

- (a) test the appropriateness of **journal entries and other adjustments**;
- (b) review **accounting estimates for bias**; and
- (c) for **significant transactions** outside the normal course of business, evaluate whether they have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

1.6 Fraud risk factors



Key term

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

HKSA
240.11b

HKSA 240
Appendix 1

HKSA 315 (Revised) states that the auditor shall evaluate whether fraud risk factors exist when collecting information from risk assessment procedures or when performing related activities.

When obtaining an understanding of the entity and its environment and the internal control, an auditor should consider whether the information obtained indicates any fraud risk factors. However, remember that fraud risk factors may not *necessarily* indicate the existence of fraud.

Auditors should exercise professional judgment in determining whether actual fraud is present.

When the following fraud risk factors appear there is a chance for fraudulent reporting to occur:

Fraud risk factors relating to fraudulent financial reporting

Operating

- Missing vouchers
- Falsified documents and unsatisfactory explanations
- Evidence of dispute
- Unexplained reconciliations or incomplete accounting records
- Computer files failure – lack of records
- Significant related party transactions occurred not in the ordinary course of business
- Dominant position in the market that may result in inappropriate or non-arm's length transactions
- Many estimates involved in the financial statements
- Significant bank accounts or subsidiaries or branches operations in tax-haven countries

Financial

- Financial and profitability levels being threatened due to high degree of competition, rapid changes in business environment
- Major decline in customer demand and increasing business failure
- Negative cash flow and operating losses
- New accounting/statutory/regulatory requirement
- Threat of bankruptcy/foreclosure/takeover

Fraud risk factors relating to fraudulent financial reporting

Pressure on management	<ul style="list-style-type: none"> • Management required to meet profitability or trend levels • Entity needs to obtain additional funds by debt or equity financing • Entity about to list, therefore required to meet exchange listing requirement • Meet financial targets established by those charged with governance or listing rules
Nature of entity's business environment	<ul style="list-style-type: none"> • Significant related party transactions not in the course of ordinary business • Complex corporate structure • Multi-location businesses
Management style	<ul style="list-style-type: none"> • Dominance by management • Non-operating internal controls – ie cut off or failure to correct • Reluctance of management to communicate with third party • High staff turnover • Ineffective accounting and information systems • Ineffective implementation of ethical standards • Investigation by Government/Police • Consistent failure to correct known material weaknesses in internal controls • Low morale among senior management • Frequent disputes between management and auditors • Limit of audit scope imposed by management
Analytical procedures	Auditor should consider any unusual or unexpected relationships that may indicate risks of material misstatement due to fraud.

When the following fraud risk factors appear there is a good chance for misappropriation of assets to occur:

Fraud risk factors relating to misappropriation of assets

Employees/ management	<ul style="list-style-type: none"> • Personal financial positions and ease to access to cash or other assets • Adverse relationships between entity and employees give motive for the misappropriation of assets
Nature of entity's business environment	<ul style="list-style-type: none"> • Circumstances occur where employees have large amount of cash on hand • Inventory items are small in size but are of high value • Easily convertible assets • Non-current assets are of small size and marketable

Fraud risk factors relating to misappropriation of assets

Internal controls	<ul style="list-style-type: none"> • Inadequate internal controls over assets • Inadequate segregation of duties • Inadequate oversight of senior management and employees responsible for assets • Inadequate recordkeeping, authorisation and approval and physical safeguards over cash investments • Lack of documentation of transactions • Lack of security in automated records • Lack of complete and timely reconciliation of assets • Inadequate management understanding of information technology
Management style	<ul style="list-style-type: none"> • Management disregarding the need for monitoring or reducing risks of misappropriation of assets • Non-financial management's excessive participation • Continuous disputes between management and shareholders

The size, complexity and ownership characteristics of the entity have a significant influence on the consideration of relevant fraud risk factors. For example, a larger entity may have better internal controls to prevent fraud.

1.7 Misstatements indicating suspected fraud

HKSA
240.28-29, 35

HKSA 240 (Clarified) requires the auditor to evaluate whether the misstatement identified is indicative of fraud and evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.

If the auditor believes the misstatements identified are the result of fraud which involved management (ie by management collusion), the auditor shall re-evaluate the assessment of the risks of material misstatement due to fraud and the impact on nature, extent and timing of audit procedures.

When numerous immaterial misstatements are identified at a specific location, it may indicate there is a risk of material misstatement due to fraud. The auditor should consider whether the fraud involves senior management as this would affect the reliability of written representations. This may indicate employees, management or third party's collusion.

1.7.1 Discussion among the engagement team

According to HKSA 240 (Clarified), discussion among the engagement team shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur.

1.8 Overall responses to assessed risks of material misstatement due to fraud at the assertion level

According to HKSA 240 (Clarified), the auditors shall design and perform further audit procedures by changing the nature, extent and timing of audit procedures that are responsive to the assessed risks of material misstatement due to fraud at the assertion level.

The following illustrates the change in nature, extent and timing of audit procedures:

Changing the nature of audit procedures	<ul style="list-style-type: none"> • Obtain more reliable and relevant audit evidence • Obtain additional corroborative evidence • Use more physical inspection or observation • Consider the source of audit evidence, ie more external evidence rather internal audit evidence, ie use more external confirmations
Changing the extent of audit procedures	<ul style="list-style-type: none"> • Increasing sample sizes • Performing analytical procedures at a more detailed level • Using CAATs for more extensive testing of electronic transactions and account files
Changing the timing of audit procedures	<ul style="list-style-type: none"> • Modifying the timing of substantive procedures • Performing substantive testing at or near the period end • Electing to apply substantive procedures to transactions occurring earlier in or throughout the reporting period

1.9 Analytical procedures performed near the end of the audit

HKSA 240.34

HKSA 240 (Clarified) requires the auditor when forming the overall conclusion to evaluate whether analytical procedures that are performed near the end of the audit indicate a previously recognised risk of material misstatement due to fraud. Auditors should consider any unusual relationships involving year-end revenue and income. Overall, this requires professional judgment.

1.10 Unable to continue the engagement

HKSA 240.38

When the auditor encounters **exceptional circumstances** that affect the auditor's ability to continue performing the audit, HKSA 240 (Clarified) requires the auditor to:

- determine the professional and legal responsibilities applicable in the circumstances ie obligatory disclosure; or
- consider the appropriateness to withdraw from the engagement.

Examples of exceptional circumstances include the following:

- No appropriate action regarding fraud is undertaken by the entity, where auditor considers necessary;
- The auditor considers there is significant risk of material and pervasive fraud; or
- The auditor has significant concern about the competence or integrity of management or those charged with governance.

If the auditor decides to withdraw from the engagement, he shall:

- discuss with the appropriate level of management and those charged with governance about the withdrawal; or
- determine whether there is obligatory reporting to regulatory authorities.

1.11 Written representations

HKSA 240.39

HKSA 240 (Clarified) requires the auditor to obtain **written representations** from management and those charged with governance that they:

- acknowledge their **responsibility** for the design, implementation and maintenance of internal control to prevent and detect fraud;

- (b) have disclosed to the auditor **management's assessment** of the risk of fraud in the financial statements;
- (c) have disclosed to the auditor their **knowledge of fraud/suspected fraud** involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements;
- (d) have disclosed to the auditor their **knowledge of any allegations of fraud/suspected fraud** communicated by employees, former employees, analysts, regulators or others; or
- (e) acknowledge the effects of those **uncorrected financial misstatements** aggregated as a whole that are immaterial to the financial statements.

1.12 Communication to management and those charged with governance

HKSA
240.40-43

If the auditor identifies fraud or receives information that a fraud may exist, the auditor shall report this on a **timely basis** to the **appropriate level of management**.

If the auditor identifies or suspects fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements, he shall communicate this on a **timely basis** to **those charged with governance**.

The auditor also needs to consider whether there is a responsibility to report to the **regulatory or enforcement authorities** – the auditor's professional duty of **confidentiality** may be **overridden** by **laws and statutes** in certain jurisdictions.

For material deficiencies in internal controls, the auditor should communicate with management.

1.13 Documentation

HKSA 240.44

The auditor must document:

- the significant decisions as a result of the team's discussion of fraud
- the identified and assessed risks of material misstatement due to fraud
- the overall responses to assessed risks
- results of specific audit tests
- any communications with management; or
- reasons for concluding that the presumption that there is a risk of fraud related to revenue recognition is not applicable.



Self-test question 1

Tom is the Human Resources Manager of XXXX Limited in Hong Kong. XXXX Limited has a number of production and management contracts with the public sector. Tom has created ten fictitious employees in the company's factory payroll. A number of pay cheques were issued to these ten fictitious employees from October to December 20X6.

TUV & Co have been the auditors of XXXX Limited for the last two years, and the audit for the year ended 31 December 20X6 is currently in progress. Before the discovery of Tom's activities, TUV & Co had assessed the risk of material misstatement due to fraud at the financial statement level as low after performing the specific risk assessment procedures as required by auditing standards.

Required

- (a) Explain the possible impacts of Tom's activities on XXXX Limited's financial statements.

(6 marks)

- (b) Explain how Tom's activities may affect the risk assessment and the audit work responsive to the assessed risk of material misstatement due to fraud. **(9 marks)**

HKICPA May 2007

(The answer is at the end of the chapter)

2 Laws and regulations



Topic highlights

Auditors must be aware of laws and regulations as part of their planning and must be aware of any statutory duty to report non-compliance by the entity.

2.1 Legal requirements relating to an entity

Entities are increasingly subject to laws and regulations with which they must comply.

HKSA 250 (Clarified) *Consideration of Laws and Regulations in an Audit of Financial Statements* provides guidance on the auditor's responsibility to consider laws and regulations in an audit of financial statements.

The provisions of those laws or regulations have a direct effect on the entity's financial statements in that they determine the reported amounts and disclosures in the financial statements.

Other laws or regulations are to be complied with by management but these laws and regulations do not have a direct effect on an entity's financial statements.



Key term

Non-compliance refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

HKSA 250.11

Such acts include transactions entered into by the entity, or on its behalf by its management or employees. It does *not* include personal misconduct. Non-compliances may result in financial consequences, like fines and litigation and non-financial consequences, such as loss of reputation.

2.2 Responsibility of management and those charged with governance

HKSA 250.3

It is management's responsibility, with the oversight of those charged with governance, to ensure that the entity complies with the relevant laws and regulations.

The following policies and procedures, among others, may be implemented by management to assist in the prevention and detection of non-compliance with laws and regulations.

- Monitor legal requirements** and ensure that operating procedures are designed to meet these requirements;
- Institute and operate** appropriate systems of **internal control** including internal audit and an audit committee;
- Develop, publicise and follow a code of conduct**;
- Ensure **employees** are properly **trained** and **understand the code of conduct**;

- (e) **Monitor compliance** with the code of conduct and act appropriately to **discipline** employees who fail to comply with it;
- (f) **Engage legal advisers** to assist in monitoring legal requirements; or
- (g) **Maintain a register** of significant laws with which the entity has to comply within its particular industry and a record of complaints.

HKSA 250.4-8, 10

2.3 Responsibility of the auditor

As with fraud, the auditor is not, and cannot be held responsible for preventing and detecting non-compliance. There is an unavoidable risk that some material misstatements in the financial statements go undetected, even though the audit is properly planned and performed.

2.3.1 Categories of laws and regulations

HKSA 250 (Clarified) distinguishes the auditor's responsibilities in relation to compliance with two different categories of law and regulation as follows:

- (a) The provisions of those laws and regulations generally recognised to have a **direct effect** on the determination of material amounts and disclosures in the financial statements; and
- (b) **Other laws and regulations** that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance may be fundamental to the business operations ie causing going concern problems or material penalties.

For those which have a direct effect the auditor is required to obtain sufficient appropriate audit evidence regarding compliance. For other laws and regulations the auditor is required to perform procedures to help identify non-compliance (see Section 2.3.4).

2.3.2 Obtaining an understanding of the entity and its environment

HKSA 250 (Clarified) requires the auditor to obtain a general understanding of:

- (a) the legal and regulatory framework applicable to the entity, industry or the business segment the entity operates; and
- (b) how the entity is complying with that framework.

2.3.3 Ways to obtain a general understanding of the legal and regulatory framework

Auditors may use the following ways to obtain general understanding of the legal and regulatory framework:

- (a) **Use the auditor's existing understanding** of the entity's industry, regulatory and other external factors;
- (b) **Update the understanding** of those laws and regulations that **directly** determine the reported amounts and disclosures in the financial statements;
- (c) **Inquire of management** as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- (d) **Inquire of management** concerning the entity's **policies and procedures** regarding compliance with laws and regulations; or
- (e) **Inquire of management** the **policies or procedures** adopted for identifying, evaluating and accounting for **litigation claims**.

2.3.4 Objective of the auditors

Under HKSA 250 (Clarified), the objectives of the auditor are to:

- (a) obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a **direct effect** on the determination of material amounts and disclosures in the financial statements;
- (b) perform specified audit procedures to help identify instances of non-compliance with **other laws and regulations** that may have a **material effect** on the financial statements; and
- (c) respond appropriately to **non-compliance or suspected non-compliance** with laws and regulations identified during the audit.

2.3.5 Risks of material misstatement due to non-compliance with laws and regulations

Certain factors will **increase** the risks of material misstatement due to non-compliance with laws and regulations not being detected by the auditor.

- (a) There are many laws and regulations, relating principally to the operating aspects of an entity, that typically do **not affect the financial statements** and are not captured by the entity's information systems relevant to financial reporting;
- (b) Non-compliance may involve conduct **designed to conceal** it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor; or
- (c) Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law.

Laws and regulations governing a business entity can vary enormously. Whether an act constitutes non-compliance is a legal matter that may be beyond the auditor's professional competence, although the auditor may have a fair idea in many cases through his knowledge and training. Ultimately such matters can only be decided by a court of law.

The further removed non-compliance is from the events and transactions normally reflected in the financial statements, the less likely the auditor is to become aware of it or recognise non-compliance.

2.3.6 Other laws and regulations

The auditor should recognise that certain other laws and regulations may have a **fundamental effect** on the operations of the entity, ie they may cause the entity to cease operations or call into question the entity's continuation as a **going concern**. For example, non-compliance with the requirements of the entity's licence or other title to perform its operations could have such an impact (for example, for a bank, non-compliance with capital or investment requirements).

The auditor must perform the following audit procedures to help identify instances of non-compliance with **other laws and regulations that may have a material effect** on the financial statements:

- (a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
- (b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

The auditor must request **written representations** from management that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements have been disclosed to the auditor.

2.4 Indications of non-compliance with laws and regulations

The auditor must remain alert throughout the audit to the possibility that **other audit procedures** may bring instances of non-compliance or suspected non-compliance to the auditor's attention. These audit procedures could include:

- (a) reading minutes;
- (b) making inquiries of management and in-house/external legal advisers regarding litigation, claims and assessments; or
- (c) performing substantive tests of details of classes of transactions, account balances or disclosures.

The following factors may indicate non-compliance with laws and regulations:

- (a) Investigations by regulatory authorities and government departments;
- (b) Payment of fines or penalties;
- (c) Payments for unspecified services or loans to consultants, related parties, employees or government employees;
- (d) Sales commissions or agents' fees that appear excessive;
- (e) Purchasing at prices significantly above/below market price;
- (f) Unusual payments in cash;
- (g) Unusual transactions with companies registered in tax havens;
- (h) Payment for goods and services made to a country different to the one in which the goods and services originated;
- (i) Payments without proper exchange control documentation;
- (j) Existence of an information system that fails to provide an adequate audit trail or sufficient evidence;
- (k) Unauthorised transactions or improperly recorded transactions; or
- (l) Adverse media comment.

2.5 Audit procedures when non-compliance is identified or suspected

HKSA
250.18-21

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain:

- (a) an understanding of the nature of the act and the circumstances in which it has occurred; and
- (b) further information to evaluate the possible effect on the financial statements.

2.5.1 Evaluation of the possible effect on the financial statements

Auditors should evaluate:

- (a) the potential financial consequences of non-compliance with laws and regulations on the financial statements whether fines, penalties or litigation claims;
- (b) whether the potential financial consequences require disclosure; and
- (c) whether the seriousness of the potential financial consequences would affect the presentation of the financial statements.

The **implications of non-compliance** in relation to other aspects of the audit have to be evaluated. The auditor should consider risk assessment, reliability of written representations, performance of

control activities and level of management or employees involved, especially when involving highest authority within an entity.

When **no remedial actions** are taken by management and those charged with governance on the non-compliances, auditors should consider withdrawal from the engagement and should consider seeking legal advice first.

2.5.2 Insufficient information about suspected non-compliances

If the auditor suspects there may be non-compliance, the auditor must discuss the matter and the findings with management and, where appropriate, those charged with governance.

The auditor must consider the need to obtain legal advice from entity's in-house legal counsel or external legal counsel if sufficient information is not provided and the matter is material.

If it is not considered appropriate to consult with the entity's legal counsel or the auditor is not satisfied with the opinion from the entity's legal counsel, the auditor may consider it appropriate to consult the auditor's legal counsel.

Finally, if the auditor cannot obtain sufficient information about suspected non-compliances, the auditor must evaluate the impact of the lack of sufficient appropriate audit evidence on the auditor's opinion.

2.6 Communicating/reporting identified or suspected non-compliance

HKSA
250.25-28

The auditor shall communicate with those charged with governance, but if the auditor suspects that those charged with governance are involved, the auditor shall communicate with the next higher level of authority such as the audit committee or supervisory board. If this does not exist, the auditor shall consider the need to obtain legal advice.

The auditor shall consider the impact on the **auditor's report** if he concludes that the non-compliance has a material effect on the financial statements and has not been adequately reflected or is prevented by management and those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance is material to the financial statements. The auditor shall express a **qualified opinion or disclaim an opinion** on the financial statements on the basis of a limitation on the scope of the audit under HKSA 705 (Clarified).

The auditor shall determine whether identified or suspected non-compliance has to be reported to the **regulatory and enforcement authorities**. Although the auditor must maintain the fundamental principle of **confidentiality**, in some jurisdictions the duty of confidentiality may be **overridden** by law or statute.

3 Following up illegal acts or fraud during the audit



Topic highlights

A firm of Certified Public Accountants must establish policies and procedures in order to meet its responsibilities in relation to money laundering.

3.1 HKSA 240 (Clarified)

HKSA
240.40-43

Where the auditor becomes aware of a suspected or actual instance of fraud which could have a material effect on the financial statements, he would:

- (a) consider whether the matter may be one that ought to be reported to a proper authority in the public interest; and where this is the case

- (b) except when he is prohibited by law from informing any party other than the proper authority or when the matter casts doubt on the integrity of those charged with governance, discuss the matter with those charged with governance, including any audit committee.

3.1.1 Duty to notify those charged with governance in writing

In respect of an identified suspected or actual instance of fraud which could have a material effect on the financial statements, the auditor would make a report direct to a proper authority in the public interest without delay and without informing those charged with governance in advance in situations where:

- (a) the auditor concludes that the matter **ought to be reported** to a proper authority in the public interest; and
- (b) the auditor is prohibited by law from informing any party other than the proper authority or the matter casts doubt on the integrity of those charged with governance

An auditor who can demonstrate that he has acted reasonably and in good faith in informing an authority of an instance of fraud which he thinks has been committed would not be held by the court to be in breach of duty to the client even if, an investigation or prosecution having occurred, it were found that there has been no offence.

An auditor may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest.

The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves **senior management**. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

3.2 HKSA 250 (Clarified)

HKSA
250.25-28

The auditor shall obtain:

- (a) an understanding of the nature of the act and the circumstances in which it has occurred; and
- (b) further information to evaluate the possible effect on the financial statements.

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence.

The auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations.

The auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations.

The auditor may consider withdrawal from the engagement, where withdrawal is possible under applicable law or regulation.

In some jurisdictions, the auditor of a financial institution has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to the supervisory authorities.

3.3 Money laundering

In recent years accountants and auditors have become subject to anti-money laundering (AML) regulations. This is largely due to the work of the inter-governmental body, the Financial Action Task Force on Money-Laundering (FATF).

A firm of Certified Public Accountants must establish sound policies and procedures to ensure that the firm meets its responsibilities under the relevant regulation in which the firm is operating. It is important that everyone who is a member of an audit engagement team is aware of the regulations, the firm's policies and procedures, and their own responsibilities regarding money laundering activities.



Key terms

Money laundering is a process by which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activities. It is a way in which money earned from criminal activities ("dirty money") is transferred and transformed so it appears to have come from a legitimate source ("clean money"). Money laundering includes a wide range of potential crimes including possessing, dealing with, or concealing the proceeds of crime.

3.3.1 Money laundering activities and process

Money laundering activities could include the following:

- Acquiring, using or possessing the proceeds of criminal activities such as drug trafficking and terrorist activities, or retaining control over the proceeds of tax evasion.
- Benefits obtained through bribery or corruption.
- Inciting, aiding, counselling or concealing such activities.

The three stages of the money laundering process are **placement, layering and integration**:

- Placement is putting money into **financial products or instruments**, including life policies, pension arrangements, unit trusts, travellers cheques, and bank deposits.
- Layering is **creating a series of transactions** so that the original source of funds is obscured and difficult to trace.
- Integration is **converting** the proceeds of money laundering **into a legitimate form**.

3.3.2 Accountants' actions related to money laundering

For accountants there are specific ways that they could **commit offences** relating to money laundering. These could include the following:

- Handling the proceeds of criminal activity, or advising on the use of such proceeds.
- Failure to report knowledge or suspicion of money laundering activities to the appropriate authority.
- Making a disclosure which is likely to prejudice an investigation into money laundering (known as "tipping off").
- Failure to comply with the specific regulatory requirements in relation to money laundering in the jurisdiction in which the accountant is operating.

3.3.3 Policies and procedures related to money laundering

The policies and procedures that a firm of Certified Public Accountants should establish in order to meet its responsibilities in relation to money laundering are described below:

(a) Appointment of a Money Laundering Reporting Officer (MLRO)

The MLRO is a nominated officer who is responsible for receiving and evaluating reports of suspected money laundering from colleagues within the firm, and making a decision as to whether further inquiry is required and if necessary making reports to the appropriate

external body. The MLRO should have an appropriate level of seniority and experience and would usually be a senior partner.

(b) **Customer identification procedures**

This is often referred to as customer due diligence (CDD), or “know your client” (KYC) procedures.

The point of these procedures is to ensure that the firm has verified the identity of clients (whether the client is an individual or an entity), and has obtained evidence of that identity. For an individual, typical evidence of identity would be a passport, driving licence, and evidence of address such as a utility bill. For an entity evidence may include a certificate of incorporation. The identification process for an entity would also involve identification of key management personnel and those people in control of the entity, and an assessment as to whether any connected individuals are politically exposed persons (PEP).

(c) **Enhanced record keeping**

Records must be kept of clients’ identity, the firm’s business relationship with them, and details of transactions with the client. All records should be kept for five years after the end of the business relationship or completion of the transactions. Internal and external reports made in connection to money laundering should also be securely kept for five years.

(d) **Communication and training**

All relevant employees should receive training so that they are aware of the main provisions of money laundering regulations, and so that they know how to recognise and deal with activities which may be money laundering. The training programme should be offered to all members of the firm with an involvement in audit engagements. Training should also be provided on the firm’s internal policies and procedures with relation to money laundering. In particular, all staff should be aware of appropriate lines of communication, and who they should report suspicions of money laundering activities to. Training should be considered for all staff, including support staff who do not carry out an advisory role.

(e) **Internal controls, risk assessment, management and monitoring**

The firm should establish systems and controls to effectively manage the risk that the firm is exposed to in terms of money laundering activities. This could include:

- client screening procedures to minimise the risk of taking on a new client with a high risk of money laundering activities
- systems and controls to ensure that training is taken/attended and understood by all relevant employees
- systems that allow periodic testing that the firms’ policies and procedures comply with legislative and regulatory requirements

All of the above contribute to the acceptance and following of firm-wide practices by all relevant individuals and can be seen as quality control measures.

3.3.4 Money laundering in Hong Kong

The Financial Action Task Force (FATF), the international AML standard-setter, completed an evaluation on Hong Kong’s AML regime in 2008 and concluded *inter alia* that we should provide statutory backing and appropriate sanctions for customer due diligence (CDD) and record-keeping requirements for financial institutions, and put into place an AML regulatory framework for remittance agents and money changers.

At present, the requirements on CDD and record keeping by financial institutions are implemented mainly through guidelines issued by the Monetary Authority (MA), the Securities and Futures Commission (SFC) and the Insurance Authority (IA) respectively. Hong Kong is required by FATF to implement improvement measures to address these deficiencies. Failure to do so will result in enhanced scrutiny by FATF and could subject Hong Kong to counter measures by other FATF members, which would hinder our development as an international financial centre.

In October 2012, the FATF recognised that Hong Kong had made significant progress in addressing the deficiencies identified in the 2008 Mutual Evaluation Report. The FATF agreed that Hong Kong should now report on any further improvements to its Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) system on a biennial update basis.

3.3.5 The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance

The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (“the Ordinance”) was gazetted on 8 July 2011. The Ordinance came into effect on 1 April 2012. The Ordinance provides for the imposition of requirements relating to customer due diligence and record-keeping on specified financial institutions, and provides for the powers of the relevant authorities.

The Ordinance seeks to improve Hong Kong's anti-money laundering regime by better alignment of the financial sector with prevailing international standards.

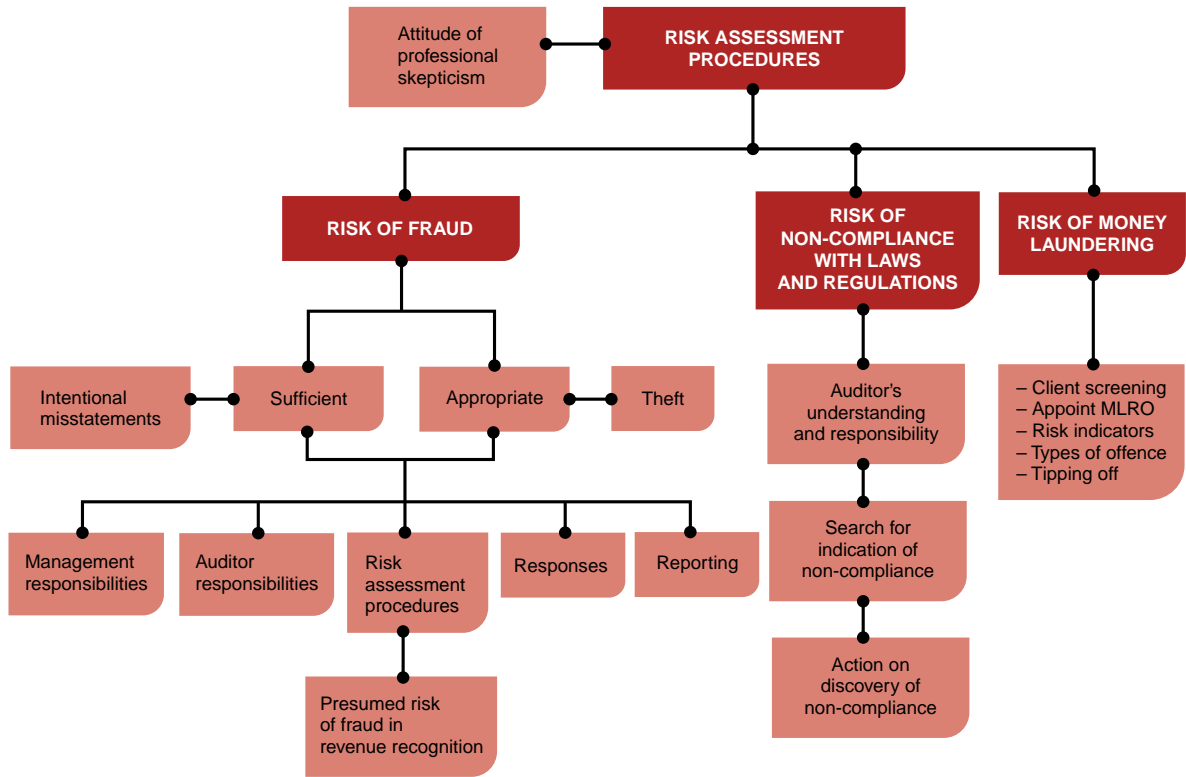
The major proposals adopted by the Ordinance include the following:

- (a) Codifying the customer due diligence requirements, which refer to the measures enabling financial institutions to establish the identity of each customer, and record-keeping requirements in line with the prevailing international standards as promulgated by the FATF;
- (b) Subjecting specified financial institutions, namely banks and deposit-taking companies (collectively referred to as authorised institutions), licensed corporations in the securities sector, authorised insurers, appointed insurance agents, authorised insurance brokers, money service operators and the Postmaster General to the statutory requirements provided in the new legislation;
- (c) Empowering the Monetary Authority (MA), the Securities and Futures Commission (SFC), the Insurance Authority (IA) and the Customs and Excise Department (C&ED) as the respective relevant authorities to supervise compliance with the statutory requirements by the specified financial institutions;
- (d) Providing for supervisory and criminal sanctions for contravention of the statutory customer due diligence and record-keeping requirements;
- (e) Putting in place a licensing regime for money service operators to be administered by C&ED; and
- (f) Establishing an independent review tribunal to review decisions made by the relevant authorities to impose supervisory sanctions and decisions related to money service operator licensing matters.

The statutory customer due diligence and record-keeping requirements largely reflect the existing requirements set out in the administrative guidelines issued by MA, SFC and IA.

Provision of criminal sanctions in addition to supervisory sanctions will ensure that Hong Kong has an effective AML regime. Many jurisdictions, including the UK, the US, Singapore, Italy and Norway, have provided for criminal offences under their AML legislation in dealing with breaches of CDD and record-keeping requirements.

Topic recap



Answer to self-test question

Answer 1

- (a) The possible impacts of Tom's activities on the financial statements of XXXX Ltd for the year ended 31 December 20X6 are as follows:
- XXXX Ltd's bank and cash were misappropriated via the payments to ten fictitious employees.
 - Staff costs are overstated, and, therefore, XXXX Ltd's overall expenditure. XXXX Ltd's profit is understated.
 - Staff benefits or staff-related costs/deductions are overstated, eg employees' insurance and severance payment provisions.
 - If staff costs are capitalised in inventories or other forms of assets (eg development expenditure), the reported amount of those assets is overstated.
 - In cases where XXXX Ltd has cost-plus contracts with its customers (ie cost-reimbursement plus margin arrangement), an overstatement of staff costs may overstate the amount of revenue (reimbursement from customers).
 - A contingent liability may arise due to a possible breach of contract if one of the purposes of overstating the headcount is to fulfil contract requirements (eg headcount requirements as set out in contracts with the Government).
 - There may be a going concern issue due to the violation of contractual requirements and other regulations for XXXX Ltd to carry on operating (and winning contracts) in the public sector outsourcing market.
 - TUV & Co's risk assessment at the financial statement level (as low) may not be appropriate as the internal controls of XXXX Ltd on its payroll may be weak or subject to management manipulation. This could cause material misstatements in other aspects of XXXX Ltd's financial statements to exist.
- (b) Before the discovery of Tom's activities, TUV & Co had assessed the risk of material misstatement due to fraud at the financial statement level as low after performing the specific risk assessment procedures as required by HKSA 240 (Clarified).

Tom's activities indicate there are weaknesses in how those charged with governance exercise oversight of management processes for identifying and responding to the risks of fraud in the entity and also weaknesses in the overall control environment.

As the HR Manager of XXXX Ltd, Tom holds a senior position. Management override of controls exists.

TUV & Co should also consider whether or not there is any evidence suggesting the susceptibility of XXXX Ltd to management fraud and the competence and integrity of management.

The insertion of fictitious employees into the payroll indicates a lack of controls in XXXX Ltd's payroll and cheque payment procedures. The internal controls that management has established to mitigate these risks are proved to be ineffective.

Depending on the pervasiveness of the audit evidence, TUV & Co may need to revise its assessment of the risk of material misstatement at the financial statement level to medium or high.

If TUV & Co obtains evidence indicating that the misappropriation of assets (pay cheques) is restricted to Tom for the last three months of the year ended 31 December 20X6 and if the amount of cash misappropriated is material to XXXX Ltd, TUV & Co may need to revise its assessment of the risk of material misstatement of the occurrence of staff costs and the existence of bank and cash to medium or high.

TUV & Co may also need to assess the risk of material misstatement of the completeness assertion of staff costs and bank & cash (due to possible misappropriation of cheques or cash by Tom to genuine employees) as medium or high. [Some candidates may argue that the payment to fictitious employees is based on payroll records which are false. Therefore, the controls in bank & cash may well be effective, but the controls in payroll records had broken down so that Tom could create fictitious employees and working/attendance records.]

According to HKSA 330 (Clarified), TUV & Co's responses to address the assessed risks of material misstatement due to fraud at the assertion level should include changing the nature, timing, and extent of audit procedures.

Changing the nature of audit procedures

As the key risks include the existence of employees, the occurrence of staff costs and the existence and completeness of bank and cash, substantive procedures may become more important, eg physical verification meetings with individual employees, physical observation of pay cheque distribution, matching the payroll to personnel files and vouching clock cards or time sheets.

Without Tom's activities, TUV & Co may rely on the internal controls of XXXX Ltd and carry out more tests of controls in the payroll and pay cheque procedures.

Changing the timing of audit procedures

In some cases, audit work at an interim date can make the year end audit more effective. However, Tom's activities took place during the last three months of the year ended 31 December 20X6, and any audit conclusions reached based on audit procedures completed at an interim date may not be extended to the year end.

Therefore, it is not effective to carry out any substantial amount of audit work at an interim date.

Changing the extent of audit procedures

TUV & Co may increase sample sizes when performing tests of details eg physical verification meetings with individual employees, physical observation of pay cheque distribution, matching payroll to personnel files and vouching clock cards or time sheets.

TUV & Co may perform analytical procedures at a more detailed level, eg comparison of wages and salaries, MPF, staff-related costs/deductions of different periods, and among different shifts, product lines and factories. Without Tom's activities, TUV & Co may perform these analytical procedures at the company level only.

Exam practice



ABC Limited

36 minutes

ABC Limited ("ABC") is a company incorporated in Hong Kong. ABC's business was very successful during the period 20X5-X8, and most of its customers are financial institutions based in the US. Mr Kwok is a CPA (Practising) and has just started planning the audit of ABC's financial statements for the year ended 30 June 20X9. Ms. Chan, the Chief Executive Officer of ABC, has discussed the following matters with Mr. Kwok:

- (1) Notwithstanding the recent US sub-prime mortgage crisis, Ms. Chan does not think customers in the US will have any difficulties in settling trade debts. However, a general allowance at 1% of the outstanding balances has been maintained as a contingency reserve against losses from irrecoverable and doubtful receivables.
- (2) Ms. Chan provides certain figures from ABC's accounting records to Mr. Kwok as follows:

	<i>Unaudited</i>	<i>Audited</i>
	<i>Year ended 30 Jun 20X9</i>	<i>Year ended 30 Jun 20X8</i>
	\$'million	\$'million
Trade receivables from customers in the US	27	20
Trade receivables from other customers	<u>6</u>	<u>5</u>
Total trade receivables	<u>33</u>	<u>25</u>
	\$'million	\$'million
Sales to customers in the US	110	100
Sales to other customers	<u>55</u>	<u>50</u>
Total sales	<u>165</u>	<u>150</u>

- (3) Ms. Chan expects ABC to be ready for listing on the Hong Kong Stock Exchange in the near future in order to stay competitive.
- (4) Ms. Chan explains that ABC has recently changed the remuneration package for senior managerial staff linking it more directly to ABC's sales.
- (5) Ms. Chan explains that ABC has recently established an affiliated entity in the US to provide certain support services for ABC's main products.

Required

- (a) Define the auditor's responsibility towards the risks of fraud in financial statements. **(3 marks)**
- (b) Define fraud risk factors and describe the three conditions that are generally present when fraud exists. **(3 marks)**

- (c) Explain four main fraud risk factors identified from the audit of ABC's financial statements for the year ended 30 June 20X9. **(8 marks)**
- (d) Explain how, as part of the audit of ABC's financial statements, Mr. Kwok may identify any unusual or unexpected relationships amongst the figures provided by Ms. Chan (point (2) above) that may indicate risks of material misstatement due to fraud. **(6 marks)**

(Total = 20 marks)

HKICPA May 2009

T&F Limited

29 minutes

Trading & Factory Limited ("T&F") has been producing and selling outdoor furniture and garden ornaments to North America for about ten years. T&F's founder, Mr. Lee, has occupied the roles of Chairman and Chief Executive Officer for three years, and has largely dominated its board of directors.

T&F struggled financially during 20X8-X9, but it has managed to survive through the recession and has recently presented the unaudited management accounts for the year ended 31 December 20Y0 to its auditor. Extracted below are certain key financials for the years 20X9 and 20Y0.

	<i>Extracts from unaudited management accounts for the year ended 31 December 20Y0</i>	<i>Extracts from audited financial statements for the year ended 31 December 20X9</i>
	HK\$'000	HK\$'000
Sales	482,100	254,300
Gross margin	30%	29%
Net profit before tax	98,100	16,200
Current ratio	0.9	1.2

Following the recent revival in performance, Mr. Lee has expressed T&F's desire to go for a listing within a year or two.

Due to the lack of financial expertise on the board and without a separate audit committee, T&F's board has been relying on the management letter from its auditor to monitor the operating effectiveness of its internal controls.

Required

- (a) Explain the auditor's responsibilities for the prevention and detection of fraud in financial statements and describe the three pre-requisites generally present when a fraud takes place. **(6 marks)**
- (b) Identify and explain three fraud risk factors (other than any weaknesses in T&F's corporate governance) from the perspective of T&F's auditor. **(10 marks)**

(Total = 16 marks)

HKICPA June 2011



chapter 11

Internal control and tests of controls

Topic list

1 Internal control systems

- 1.1 Control environment
- 1.2 Entity's risk assessment process
- 1.3 Information system relevant to financial reporting
- 1.4 Control activities
- 1.5 Monitoring of controls
- 1.6 Controls for significant risks
- 1.7 Limitations of accounting and control systems

2 The use of internal control systems by auditors

- 2.1 Recording accounting and control systems

3 Tests of controls

- 3.1 Confirming understanding
- 3.2 When to perform tests of controls
- 3.3 Reliance on evidence obtained in prior periods
- 3.4 Increase the extent of tests of controls
- 3.5 Evaluating the operating effectiveness of controls

4 Internal controls in a computerised environment

- 4.1 General controls
- 4.2 Application controls
- 4.3 Documentation
- 4.4 Testing of automated controls

5 Communicating deficiencies in internal control

- 5.1 Meaning of deficiencies
- 5.2 Requirement of auditor
- 5.3 Action taken by management and those charged with governance

Learning focus

Auditors should evaluate the internal control system in order to determine whether to rely on the entity's internal controls in order to reduce the level of substantive testing.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.09	Audit procedures	3
2.09.05	Explain the importance of internal control to auditors and the execution of tests of control	
2.09.06	Explain how auditors identify weaknesses in internal control systems and how those weaknesses limit the extent of auditors' reliance on those systems	
2.10	Audit evidence	3
2.10.04	Explain the need to modify the audit strategy and audit plan following the results of tests of control	
2.13	Reporting	3
2.13.01	Discuss and provide examples of how the reporting of internal control weaknesses and recommendations to overcome those weaknesses are provided to management	
4.02	Categories and types of controls	3
4.02.01	State examples of controls in a computerised system	
4.02.02	Define and give examples of general and application controls	

1 Internal control systems



Topic highlights

The auditors must **understand** the **accounting system** and **control environment** in order to determine their audit approach.



Key term

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.

HKSA 315.4c

HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with the whole area of controls.

Internal control has five elements:

- The control environment;
- The entity's risk assessment process;
- The information system relevant to financial reporting;
- Control activities; and
- Monitoring of controls.

HKSA 315 (Revised) requires that the auditor shall obtain an understanding of internal controls relevant to the audit. Most controls relevant to the audit are likely to relate to financial reporting but there might be controls relevant to operations and compliances objectives. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit.

In obtaining an understanding of internal control, the auditor must understand and evaluate the **design** of the internal control (ie is it capable of preventing, detecting and correcting material misstatements?) and the **implementation** of that control (ie has it been operated correctly in that year?) by performing procedures in addition to inquiry of the entity's personnel. In the following sub-sections, we look at each of the elements of internal control in turn.

1.1 Control environment



Key term

The **control environment** is the framework within which operational controls operate. Its effectiveness is very much determined by management's attitudes, awareness of risk and actions and the importance placed on internal control within the entity.

1.1.1 Effect of control environment on auditor's risk assessment

HKSA 315.14

The control environment sets the **tone for an organisation**. It provides discipline and structure and strongly influences the control consciousness of the people within the organisation. A strong control environment, supported by a clear and effectively communicated commitment from senior management influences the auditor's assessment of the effectiveness of other controls.

It does not, on its own, guarantee the effectiveness of the overall control system, but reduces the risks of material misstatement. A weak control environment can undermine the effectiveness of specific operational controls.

Controls are more likely to operate well in an environment where they are regarded as being of importance, that is, in entities where the ethos is set at the most senior levels of the company that honest and transparent behaviour is paramount and deviations from ethical practice will not be accepted. The responsibility for individual areas is then cascaded down through tiers of management in the form of operational controls. The auditors, will perform procedures to ascertain whether certain controls exist and are routinely adhered to. For example, the auditor may check that a particular payment has been made to a supplier on an approved list.

HKSA 315 (Revised) states that auditors must understand an entity's control environment. The types of check described above are relatively easy to perform as walk-through tests but auditors must also use observation and inquiry to assess whether:

- management, with the oversight of those charged with governance, has created and maintains a **culture** of honesty and ethical behaviour
- the strengths in the control environment provide an **adequate foundation** for the other elements of internal control and whether those elements are weakened by deficiencies in the control environment.

The following table illustrates this:

Control environment	
Management's integrity and ethical values	<ul style="list-style-type: none"> • Essential elements which influence the effectiveness of the design, administration and monitoring of controls; and • Overall attitude, awareness and actions of management on the internal control system
Commitment to competence	<ul style="list-style-type: none"> • Management's assessment of the competency levels for particular roles and how those levels translate into requisite skills and knowledge
Participation by those charged with governance	<ul style="list-style-type: none"> • Independence from management • Experience and stature • Extent of involvement and scrutiny of activities • Type of difficult questions resolved in between internal and external auditors • Whether they understand the entity's business transactions
Management's philosophy and operating style	<ul style="list-style-type: none"> • Approach to taking and managing business risks • Attitudes and actions towards financial reporting • Attitudes towards information processing and accounting functions and personnel
Organisational structure	The framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed (including segregation of duties, job rotation and so on)
Assignment of authority and responsibility	How authority and responsibility for business activities are allocated and how reporting lines and authorisation controls are organised
Human resource policies and practices	How recruitment, induction, training, performance monitoring and career progression plans, work place counselling, remuneration, and grievance and discipline matters are conducted

Finally, the auditor should form a conclusion as to whether the control environment is **strong or weak**.

1.2 Entity's risk assessment process

HKSA 315.15

HKSA 315 (Revised) says that the auditor must understand and evaluate the internal processes of an entity for the following:

- identification of the business risks which may affect financial reporting objectives
- estimating their significance
- assessing their likelihood
- responding effectively to the issues identified.

The entity's risk assessment process assists the auditor in identifying risks of material misstatement. If the auditor believes the process fails to reflect the risk position of the entity, the auditor then evaluates whether this is because of any serious weakness in internal control.

If there is no process for risk identification in place at all, the auditor should discuss with management whether the business risks relevant to the financial reporting objectives have been assessed and addressed appropriately. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in overall internal control.

1.3 Information system relevant to financial reporting



Key term

The **information system relevant to financial reporting** is a component of internal control that includes the financial reporting system, and consists of the procedures and records established to initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.

HKSA 315.18-19

The auditor must obtain an understanding of the information system relevant to financial reporting objectives, and the following in particular:

- The classes of transactions in the entity's operations that are of most significance to the financial statements
- The procedures, within both computerised and manual systems, by which those transactions are initiated, recorded, processed, corrected, and transferred to the general ledger and reported in the financial statements
- The underlying accounting records, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions
- How the information system records events and conditions, other than transactions, that are significant to the financial statements
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures
- Controls surrounding journal entries, including non-standard journal entries used to record unusual one-off transactions or adjustments

The auditor should also obtain an understanding of how the entity **communicates** financial reporting roles and responsibilities and significant matters relating to financial reporting to management and those charged with governance or regulatory authorities.



Self-test question 1

You are the audit senior responsible for the audit of Supreme Food Limited, a Hong Kong company that runs a chain of fast food stores.

The major risk in this industry is always related to food quality which might result in damage claims by customers.

After the risk assessment conducted at the interim audit on the company's internal control system regarding the purchases of food and its preparation process, you consider the risk to be low.

However, during your final audit you discover that an incident happened one month before the year-end. A customer took legal action against the company for personal injury caused by food poisoning, claiming an amount of \$200,000 in compensation. This amount is material to the stated profit of the company, but management believes that the company has a good defense against the claim.

- (i) State TWO controls that the company should have in place to reduce the risk associated with purchases of food and its preparation in the kitchen; and
- (ii) State TWO audit procedures you should carry out during controls testing to satisfy yourself that control risk in this area is low.

(The answer is at the end of the chapter)

1.4 Control activities



Key term

Control activities are the policies and procedures that help ensure that management directives are carried out.

HKSA
315.20-21

HKSA 315 (Revised) states that the auditor shall obtain an understanding of control activities relevant to the audit. This includes an understanding of how the entity has responded to risks arising from IT. By relevant the standard means those the auditor deems it necessary to understand in order to assess the risks of material misstatement at the assertion level, and which are necessary to design further audit procedures responsive to the assessed risks.

Control activities that are relevant to the audit are:

- (a) Control activities that relate to significant risks or relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; or
- (b) Those that are considered to be relevant in the judgment of the auditor.

Examples include activities relating to authorisation, information processing, performance reviews, physical controls and segregation of duties.

Examples of control activities

Authorisation	<ul style="list-style-type: none"> • Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers
Information processing	<ul style="list-style-type: none"> • General IT controls – policies and procedures that relate to many applications such as program change controls • Application controls – applying to the processing of individual applications
Performance review	<ul style="list-style-type: none"> • Reviews and analyses of actual performance versus budgets, forecasts • Comparing different sets of data by analysing of the relationships and investigate the difference • Comparing internal data with external sources of information • Review of functional or activity performance
Physical controls	<ul style="list-style-type: none"> • Physical security of assets for prevention of theft of assets • Authorisation for access to computer programs and data files • Periodic counting and comparison with amounts shown on control records
Segregation of duties	<ul style="list-style-type: none"> • Segregation implies a number of people being involved in the accounting process • Segregation of function. The key functions that should be segregated are the carrying out of a transaction, recording that transaction in the accounting records and maintaining custody of assets that arise from the transaction • The various steps in carrying out the transaction should also be segregated

1.5 Monitoring of controls



Key term

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions.

HKSA
315.22-24

HKSA 315 (Revised) requires that the auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to the control activities relevant to the audit, and how the entity initiates corrective actions to deficiencies in its controls. The entity will use **ongoing monitoring activities** that are often built into the entity's routine operations, including regular management and supervisory activities or **separate evaluations** or a combination of the two.

Monitoring control is also used to ensure that controls continue to operate effectively over time.

If the entity has an **internal audit function**, the auditor shall assess whether the internal audit function is relevant to the audit through obtaining an understanding of the **nature of its**

responsibilities and how the internal audit function **fits** in the organisational structure, and the **activities** performed/to be performed.

The auditor shall also obtain an understanding of the **sources of the information** used in the monitoring activities and the **basis** on which management considers it reliable.

Some of the monitoring controls are:

- supervision of others – checking by others
- comparison of actual performance to budgets and analysis of the variances
- relationship of financial or operational data – sensitivity analysis
- ratio analysis
- review reconciliations
- internal auditors' evaluation

1.6 Controls for significant risks

HKSA 315.29

HKSA 315 (Revised) requires that if the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls relevant to these significant risks.

Auditors should consider whether management has specifically responded to these significant risks by:

- implementing control activities such as a review of assumptions by experts or senior management;
- documenting the processes for estimation; and
- approval by those charged with governance.

Be aware, any failure by management to implement controls to significant risk is an indicator of a **significant deficiency** in internal control.

1.7 Limitations of accounting and control systems

An internal control system can provide **reasonable assurance** but not absolute assurance that the objectives are reached, because there are **inherent limitations**.

- (a) The **costs** of control **not outweighing** their **benefits**
- (b) The potential for **human error**
- (c) **Collusion** between employees
- (d) The possibility of **controls** being **by-passed** or **overridden** by management
- (e) Controls being **designed to cope** with **routine** but **not unusual transactions**

These limitations indicate why auditors are unable to obtain all their audit evidence from tests of the systems of internal control. **Human error** and **potential for fraud** are the most serious challenges to any internal control system, as any system is only as reliable as the people who operate it. An entity may be sensitive to the warning signs and can encourage good working practices such as segregation of duties and rotation of staff, ensuring all holiday is taken and so on. However, if employees decide to commit frauds by collusion, or management commit frauds by overriding systems, they probably do so in the knowledge that they can manipulate the accounting system to conceal their fraudulent activity.

2 The use of internal control systems by auditors



Topic highlights

The auditors shall assess the **adequacy** of the systems as a basis for the financial statements and shall identify **risks** of material misstatements to provide a basis for designing and performing further audit procedures.

Auditors are only concerned with assessing policies and procedures which are relevant to the financial statements. Auditors shall:

- **assess the adequacy** of the accounting system as a basis for preparing the financial statements;
- **identify** the types of **potential misstatements** that could occur in the financial statements;
- **consider factors** that affect the **risk of misstatements**; and
- **design appropriate audit procedures.**

The assessment of the controls of an entity will have an impact on that risk assessment.

Risks arising from **poor control environments** are unlikely to be confined to particular assertions in the financial statements, and, if severe, may even raise questions about whether the financial statements are capable of being audited, that is, if control risk is so high that audit risk cannot be reduced to an acceptable level.

On the other hand, some **control procedures** may be closely connected to an assertion in the financial statements, for example, controls over the inventory count are closely connected with the existence and completeness of inventory in the financial statements.

There may be occasions where substantive procedures alone are not sufficient to address the risks arising. Where such risks exist, auditors shall **evaluate the design** and **determine the implementation** of the controls, that is by **controls testing**. This is most likely to be the case in a system which is highly computerised and which does not require much manual intervention.

2.1 Recording accounting and control systems



Topic highlights

The auditors must keep a record of the entity's systems which must be updated each year. This can be done through the use of narrative notes, flowcharts, questionnaires or checklists.

There are several techniques for recording the assessment of control risk, that is, the system. One or more of the following may be used depending on the complexity of the system:

- Narrative notes
- Questionnaires
- Flowcharts
- Checklists

Whatever method of recording is used, the record will usually be retained on the permanent file and updated each year. We will look at the use of questionnaires in a little more detail here. There are two types, each with a different purpose:

- **Internal Control Questionnaires (ICQs)** are used to ask whether controls exist which meet specific control objectives. Although there are many different forms of ICQ in practice, they all conform to the following basic principles:

- (a) They comprise of a list of questions designed to determine whether desirable controls are present
- (b) They are formulated so that there is one to cover each of the major transaction cycles.

Since it is the primary purpose of an ICQ to evaluate the system rather than to describe it, one of the most effective ways of designing the questionnaire is to phrase the question so that all the answers can be given as “YES” or “NO” with a “NO” answer indicating a deficiency in the system.



Example

Are purchase invoices checked to goods received notes before being passed for payment?

YES/NO/COMMENT

A “NO” answer to the question clearly indicates a deficiency in the company’s payment procedures.

- **Internal Control Evaluation Questionnaires (ICEQs)** are used to determine whether there are controls which prevent or detect specified errors or omissions. This is achieved by reducing the control criteria for each transaction stream down to a handful of key questions (or control questions). The characteristic of these questions is that they concentrate on the significant errors or omissions that could occur at each phase of the appropriate cycle if controls are deficient.



Example

Is there reasonable assurance that:

Receipt of goods or services is required in order to establish a liability?

Each key control question is supported by detailed points to be considered.



Example

Is segregation of duties satisfactory?

Are controls over relevant master files satisfactory?

Is there a record that all goods received have been checked for weight or number and quality and damage?

3 Tests of controls



Topic highlights

If the auditors believe the system of controls is strong, they may choose to test controls to assess whether they can rely on the controls having operated effectively.



Key term

Tests of controls are the audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

HKSA 330.4b

3.1 Confirming understanding

In order to confirm their understanding of the control systems, auditors will often carry out **walk-through tests**. This is where they pick up a transaction and follow it through the system to see whether all the key controls identified during inquiry of relevant parties were in operation with regard to that transaction.

For any material deficiencies in the internal control system, the auditor must communicate to:

- those charged with governance; and
- management of an appropriate level of responsibility.

3.2 When to perform tests of controls

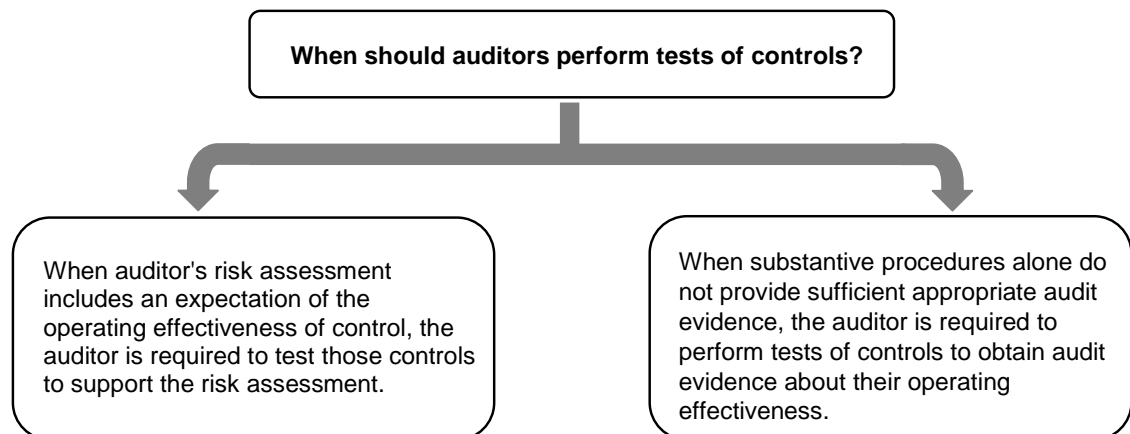
HKSA 330.10

Under HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks*, **tests of controls** are tests performed to obtain audit evidence about the effectiveness of the:

- design of the accounting and internal control systems as documented during the risk assessment process, ie whether they are suitably designed to prevent, or detect and correct, material misstatement at the assertion level; and
- operation of the internal controls identified throughout the period of intended reliance.

Auditors should consider the following to obtain audit evidence about the operating effectiveness of the controls:

- **How** controls were applied;
- The **consistency** with which they were applied during the period; and
- **By whom and by what means** they were applied.



3.2.1 Auditor's responsibility for tests of controls

The auditor should identify and assess the risks of material misstatements at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures.

The auditor should determine risks that require special audit consideration and consider whether the controls are implemented.

If it is not possible or practicable to reduce the risks of material misstatement at the financial statement level to an acceptably low level with audit evidence obtained by substantive testing, then the auditor should evaluate the design and implementation of the entity's controls.

For some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of **indirect controls** ie reviewing exception reports or reviewing controls over the accuracy of the information in the reports.

3.2.2 Methods to perform tests of controls

HKSA 330 (Clarified) requires that, in designing and performing tests of controls, the auditor shall perform other audit procedures such as the following to obtain audit evidence about the operating effectiveness of the controls.

Other audit procedures may include:

- (a) **Inspection of documents** supporting controls or events to gain audit evidence that internal controls have operated properly, eg verifying that a transaction has been authorised;
- (b) **Inquiries about internal controls** which leave no audit trail, eg determining who actually performs each function not merely who is supposed to perform it;
- (c) **Reperformance of control procedures**, eg reconciliation of bank accounts, to ensure they were correctly performed by the entity;
- (d) **Examination of evidence of management views**, eg minutes of management meetings;
- (e) Testing of internal controls operating on **computerised systems** or over the overall IT function, eg access controls; and
- (f) **Observation of controls** to consider the manner in which the control is being operated.

Deviations in the operation of controls (caused by change of staff or similar) may increase control risk and tests of controls may need to be modified to confirm effective operation during and after any change.

The use of **computer-assisted audit techniques** (CAATs) may be appropriate and these are discussed in detail in Chapter 20.

In a continuing engagement, the auditor will be aware of the accounting and internal control systems through work carried out previously but will need to update the knowledge gained and consider the need to obtain further audit evidence of any changes in control.

3.3 Reliance on evidence obtained in prior periods

HKSA
330.13-15

The auditor performs audit procedures to establish the continuing relevance of audit evidence **obtained in prior periods** when the auditor plans to use the audit evidence in the current period.

In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall consider the following:

- (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;
- (b) The risks arising from the characteristics of the control, including whether it is manual or automated;
- (c) The effectiveness of general IT controls;
- (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;
- (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and
- (f) The risks of material misstatement and the extent of reliance on the control.

For example, in performing the prior audit, the auditor may have determined that an automated control was functioning as intended. The auditor obtains audit evidence to determine whether **changes to the automated control** have been made that affect its continued effective functioning, for example, through inquiries of management and the inspection of logs to indicate what controls have been changed.

Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

3.3.1 Audit evidence from tests of controls

When the auditor intends to use audit evidence about the operating effectiveness of controls obtained in **prior audits**, the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the previous audit. To do so, the auditor should make enquiries in combination with observation or inspection procedures.

If the auditor plans to rely on controls that have **changed since they were last tested**, the auditor should test the operating effectiveness of such controls in the current audit. Changes may affect the relevance of the audit evidence obtained in prior periods such that there may no longer be a basis for continued reliance.

The auditor considers testing the controls, if any, over the entity's preparation of information used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period.

3.3.2 Significant risks

For any controls intended to mitigate any **significant risk** related to the assessed risk of material misstatement at the assertion levels, auditor **must** obtain audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period. The auditor **cannot** rely on evidence obtained from prior period.

3.3.3 Tests on controls for an interim period

When auditor has performed tests of controls during an interim period, the auditor should obtain audit evidence about significant changes to those controls subsequent to the interim period and determine what additional audit evidence should be obtained for the **remaining period**.

3.3.4 Audit evidence from substantive testing

The use of audit evidence from the performance of substantive procedures in a prior audit is not sufficient to address a risk of material misstatement in the current period. In most cases, audit evidence from the performance of substantive procedures in a prior audit provides little or no audit evidence for the current period. In order for audit evidence obtained in a prior audit to be used in the current period as substantive audit evidence, the audit evidence and the related subject matter must not fundamentally change.

As required by HKSA 500 (Clarified), if the auditor plans to use audit evidence obtained from the performance of substantive procedures in a prior audit, the auditor performs audit procedures during the current period to establish the continuing relevance of the audit evidence.

When relevant to the audit, the auditor also considers other information such as:

- information obtained from the auditor's client acceptance or continuance process
- experience gained on other engagements performed for the entity, for example, engagements to review interim financial information.

3.3.5 Communication of deficiencies in internal control

Significant deficiencies in internal controls shall be communicated in writing to those charged with governance in a **report to management** in accordance with HKSA 260 (Clarified) and HKSA 265 (Clarified).

Such a report would be issued at the conclusion of the interim audit or at the conclusion of the final audit if no interim audit is undertaken.

3.4 Increase the extent of tests of controls

HKSA 330.9

HKSA 330 (Clarified) requires that, in designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence, the greater the reliance the auditor places on the effectiveness of a control.

The auditor shall consider the following factors when determining the extent of tests of controls:

- (a) Frequency of the performance of the control;
- (b) Length of time during the audit period that the auditor is relying on the operating effectiveness of internal controls;
- (c) The expected rate of deviation in internal controls;
- (d) Relevance and reliability of the audit evidence regarding the operating effectiveness of the control at assertion level; and
- (e) Extent of audit evidence from tests of other controls.

The auditor may use sampling techniques when performing tests of controls and the sample size for tests of controls may be affected by:

- auditor's risk assessment;
- tolerable rate of deviation;
- expected rate of deviation of the tested population; and
- auditor's desired level of assurance.

The auditor's assessed risk of material misstatement would increase when there is an unexpectedly high sample deviation rate of tests of controls.

3.5 Evaluating the operating effectiveness of controls

HKSA 330.17

HKSA 330 (Clarified) requires that if deviations from controls upon which the auditor intends to rely are detected, the auditor shall determine whether:

- any additional tests of controls are necessary;
- substantive testing is needed to be performed to address the potential risks of misstatement; and to
- consider whether the tests of controls performed provide an appropriate basis for auditors to rely on the controls.

The auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate existence of a significant deficiency in internal control.



Self-test question 2

A proper understanding of internal controls is essential to auditors in order that they understand the business and are able to effectively plan and execute tests of controls and an appropriate level of substantive procedures.

You are the auditor of an investment entity, Charter Great Limited ("Charter Great"), that pays its staff payroll by bank auto transfer and in cash. The entity also uses a small stand-alone computer for maintaining its payroll records.

Required

For the payroll charges and payroll balances (including cash) in the financial statements of Charter Great:

- (a) describe the external auditor audit's objectives;

- (b) list the tests of controls and substantive procedures that will be applied in order to achieve the audit objectives identified in (b) (i) above.

(The answer is at the end of the chapter)

4 Internal controls in a computerised environment



Topic highlights

There are special considerations for auditors when a system is computerised. IT controls comprise **general** and **application** controls.

The overall objective and scope of an audit do not change in a computer environment. However, as the means of processing of transactions and the media of storage of data are different from those of a manual system.

The internal controls in a computerised environment include both manual procedures and procedures designed into computer programs. Such control procedures comprise two types of control, **general controls** and **application controls**. (The impact of IT on the audit process is covered in more detail in Chapter 20.)



Key terms

General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data centre and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development and maintenance. Examples include IT policies, standards, and guidelines pertaining to IT security and information protection, application software development and change controls, segregation of duties, service continuity planning, IT project management, etc.

Application controls are manual or automated procedures that typically operate at a business level. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. Examples include system edit checks of the format of entered data to help prevent possible invalid input, system enforced transaction controls that prevent users from performing transactions that are not part of their normal duties, and the creation of detailed reports and transaction control totals that can be balanced by various units to the source data to ensure all transactions have been posted completely and accurately.

4.1 General controls

The overall audit objective in reviewing the general controls is to ensure that the controls and procedures are adequate to provide secure, effective and efficient day-to-day operation of the computer facilities. Examples of controls and procedures which together form the general controls are shown in the following table.

General controls	Examples
<p>Development of computer applications</p>	<p>Standards over systems design, programming and documentation</p> <p>Full testing procedures using test data</p> <p>Approval by computer users and management</p> <p>Segregation of duties so that those responsible for design are not responsible for testing</p> <p>Installation procedures so that data is not corrupted in transition</p> <p>Training of staff in new procedures and availability of adequate documentation</p>
<p>Prevention or detection of unauthorised changes to programs</p>	<p>Segregation of duties</p> <p>Full records of program changes</p> <p>Password protection of programs so that access is limited to computer operations staff</p> <p>Restricted access to central computer by locked doors, keypads</p> <p>Maintenance of programs logs</p> <p>Virus checks on software: use of anti-virus software and policy prohibiting use of non-authorized programs or files</p> <p>Back-up copies of programs being taken and stored in other locations</p> <p>Control copies of programs being preserved and regularly compared with actual programs</p> <p>Stricter controls over certain programs (utility programs) by use of read-only memory</p>
<p>Testing and documentation of program changes</p>	<p>Complete testing procedures</p> <p>Documentation standards</p> <p>Approval of changes by computer users and management</p> <p>Training of staff using programs</p>
<p>Controls to prevent wrong programs or files being used</p>	<p>Operation controls over programs</p> <p>Libraries of programs</p> <p>Proper job scheduling</p>
<p>Controls to prevent unauthorised amendments to data files</p>	<p>Password protection</p> <p>Restricted access to authorised users only</p> <p>Authorisation of jobs prior to processing (eg authorised data input forms)</p>

General controls	Examples
Controls to ensure continuity of operation	<p>Storing extra copies of programs and data files off-site</p> <p>Protection of equipment against fire and other hazards</p> <p>Back-up power sources</p> <p>Disaster recovery procedures, eg availability of back-up computer facilities</p> <p>Maintenance agreements and insurance</p>

The auditors will wish to test some or all of the above general controls, having considered how they affect the computer applications significant to the audit.

General controls that relate to some or all applications are usually interdependent controls, ie their operation is often essential to the effectiveness of application controls. As application controls may be useless when general controls are ineffective, it will be more efficient to review the design of general controls first, before reviewing the application controls.

4.2 Application controls

The purpose of application controls is to establish **specific control procedures** over the accounting applications in order to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis.

Before evaluating the application controls, it will be necessary for an auditor to obtain a reasonable understanding of the system. The auditor will obtain an understanding of the following:

- (i) indicating the major transactions;
- (ii) describing the transaction flow and main output;
- (iii) indicating the major files maintained; and
- (iv) providing approximate figures for transaction volumes.

Application control requirements may be divided into:

- (i) Input control
- (ii) Processing control
- (iii) Master/ Standing Data File control
- (iv) Output control

Application controls include the following:

Application controls	Examples
Controls over input: completeness	<p>Manual or programmed agreement of control totals</p> <p>Document counts</p> <p>Edit checks of input data</p> <p>Numerical sequence checks with manual follow-up of exception reports</p> <p>One-for-one checking of processed output to source documents</p> <p>Programmed matching of input to an expected input control file</p> <p>Procedures over resubmission of rejected controls</p>

Application controls	Examples
Controls over input: accuracy	<p>Programs to check data fields (for example, value, reference number, date) on input transactions for plausibility:</p> <ul style="list-style-type: none"> • Digit verification (reference numbers are as expected) • Reasonableness test (sales tax to total value) • Existence checks (customer name) • Character checks (no unexpected characters used in reference) • Necessary information (no transaction passed with gaps) • Permitted range (no transaction processed over a certain value) <p>Manual scrutiny of output and reconciliation to source</p> <p>Agreement of control totals (manual/programmed)</p>
Controls over input: authorisation	<p>Manual checks to ensure information input was:</p> <ul style="list-style-type: none"> • authorised • input by authorised personnel
Controls over processing	<p>Similar controls to input must be in place when input is completed, for example, batch reconciliations</p> <p>Screen warnings can prevent people logging out before processing is complete</p>
Controls over master files and standing data	<p>One-to-one checking</p> <p>Cyclical reviews of all master files and standing data</p> <p>Record counts (number of documents processed) and hash totals (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions</p> <p>Controls over the deletion of accounts that have no current balance</p>
<p>Controls may be carried out by IT personnel, users of the system, a separate control group and may be programmed into application software. The auditors may wish to test the following application controls:</p>	
Testing of application controls	
Manual controls exercised by the user	<p>If manual controls exercised by the user of the application system are capable of providing reasonable assurance that the system's output is complete, accurate and authorised, the auditors may decide to limit tests of controls to these manual controls.</p>
Controls over system output	<p>If, in addition to manual controls exercised by the user, the controls to be tested use information produced by the computer or are contained within computer programs, such controls may be tested by examining the system's output using either manual procedures or computers. Such output may be in the form of magnetic media, microfilm or printouts. Alternatively, the auditor may test the control by performing it with the use of computers.</p>
Programmed control procedures	<p>In the case of certain computer systems, the auditor may find that it is not possible or, in some cases, not practical to test controls by examining only user controls or the system's output. The auditor may consider performing tests of controls by using computers, reprocessing transaction data or, in unusual situations, examining the coding of the application program.</p>

As we have already noted, general controls may have a pervasive effect on the processing of transactions in application systems. If these general controls are not effective, there may be a risk that misstatements occur and go undetected in the application systems. Although weaknesses in general controls may preclude testing certain application controls, it is possible that manual procedures exercised by users may provide effective control at the **application level**.

4.3 Documentation

Adequate documentation of both general and application controls is crucial. Proper documentation by the entity ensures that adequate and up-to-date system documentation is maintained. The entity should have procedures to ensure that:

- (i) system documentation is sufficiently comprehensive;
- (ii) documentation is updated to reflect system amendments; and
- (iii) a back-up copy of the documentation is held.

Without good documentation, it will be difficult to ensure that controls operate on a continuous basis and there will also be greater likelihood of error. Good documentation procedures reduce the risk of users making mistakes or exceeding their authority. A review of comprehensive, up to date documentation should aid the auditor in gaining an understanding and may help to identify particular audit risks.



Self-test question 3

You are the audit senior on the XYZ Limited (“XYZ”) audit. XYZ is a distributor of hair care products including shampoos, conditioners and mousses. XYZ uses an online computer system. No goods are manufactured in-house. XYZ maintains an inventory of raw materials and subcontracts the manufacture of its products to third parties. Approximately 50 suppliers and ten sub-contractors are used and all have proven themselves to be reliable. All finished goods are sent to customers directly from the sub-contractors, who send a weekly statement to XYZ. Your assistant has prepared the following notes about the inventory system.

Purchase orders are automatically generated by the computer when inventories of any raw material fall below 70 % of the prior month's usage. The purchase orders contain the following details:

- Date
- Supplier name and address
- Raw materials needed

Three copies of the purchase order are produced and distributed as follows:

Copy 1 – to warehouse to enable follow up of late orders

Copy 2 – filed by accounts clerk in date order

Copy 3 – sent to supplier

When raw material inventories are received, the bar code attached to the delivery boxes by the supplier is scanned into the system. A two-part Goods Received Note (“GRN”) is then produced:

Copy 1 – matched to warehouse copy of purchase order by stores staff

Copy 2 – filed by accounts clerk in date order

The scanning process is aborted if the codes do not match those on the master file. Production orders are generated on receipt of a firm order from customers.

The inventory master file contains details of existing inventory items including code and warehouse location; and approved suppliers and sub contractors.

Orders will only be generated to suppliers and sub-contractors recorded on the master file.

Required

- (a) Identify any deficiencies in the internal controls of XYZ. Discuss the implications of each of the deficiencies you have identified.
- (b) Assume that your Computer Information System “CIS” audit division is to perform tests of controls for the inventory systems described. Make a list for the CIS audit manager of the key tests that you recommend him to perform.

(The answer is at the end of the chapter)

4.4 Testing of automated controls

An automated control can be expected to function consistently unless the program is changed. In order to determine the automated control continues to function effectively, the auditor could test:

- changes in program controls;
- effectiveness of general IT controls; and
- the record of IT security.

The auditor may obtain audit evidence by inquiry or inspection to determine whether changes to the automated control have been made that affect its continued effective functioning.

5 Communicating deficiencies in internal control



Topic highlights

Auditors have responsibility to communicate appropriately to those charged with governance and management **deficiencies in internal control** that the auditor has identified in an audit of financial statements.

HKSA 265 (Clarified) *Communicating Deficiencies in Internal Control to those Charged with Governance and Management* deals with the auditor's responsibility to **communicate appropriately to those charged with governance and management** deficiencies in internal control that the auditor has identified in an audit of financial statements. The HKSA states that significant deficiencies in internal control must be communicated to those charged with governance.

The auditor may identify and discuss the deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit. This HKSA specifies which identified deficiencies the auditor is required to communicate to those charged with governance and management.

For **significant deficiencies**, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance.

For **other deficiencies** in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

5.1 Meaning of deficiencies



Key terms

HKSA 265.6

Deficiency in internal control – This exists when a control is designed, implemented or operated in such a way that it is **unable to prevent, or detect and correct**, misstatements in the financial statements on a timely basis; or a control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is **missing**.

Significant deficiency in internal control – A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

HKSA
315. A6

Significant deficiencies or not

Significance of the deficiencies depends on whether a misstatement has actually occurred, the **likelihood** that a misstatement could occur and the **potential magnitude** of the misstatement.

Indicators of significant deficiencies in internal control

Evidence of ineffective aspects of the control environment include:

- (a) Significant transactions that management is financially interested in but not being appropriately scrutinised by those charged with governance
- (b) Management fraud not prevented by the entity's internal control
- (c) Management's failure to implement appropriate remedial action on significant deficiencies previously communicated
- (d) Absence of an expected risk assessment process within the entity
- (e) Evidence of failure of entity risk assessment process
- (f) Evidence of an ineffective response to identified significant risks
- (g) Misstatements detected by audit procedures but not prevented, detected or corrected by entity's internal control
- (h) Restatement of previous financial statements due to misstatements or fraud
- (i) Management's inability to review the preparation of the financial statements

A deficiency in internal control on its own may not be sufficiently important to constitute a significant deficiency. However, a combination of deficiencies affecting the same account balance or disclosure, relevant assertion, or component of internal control may increase the risks of misstatement to such an extent as to give rise to a significant deficiency.

In some jurisdictions, the auditor may have responsibility to report directly to regulators in regulated industries. In addition, for listed entities in certain jurisdictions, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes.

5.2 Requirement of auditor

HKSA 265.7,
8, 9, 10

HKSA 265 (Clarified) requires the auditor to determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control and if so, on the basis of the audit work performed, auditors should consider whether, individually or in combination, they constitute **significant deficiencies**.

5.2.1 Discussion with management and those charged with governance

The auditor shall **discuss** the relevant facts and circumstances of his findings on deficiencies in internal control with the appropriate level of management and those charged with governance as this would provide an opportunity for the auditor to alert management on a timely basis to the existence of deficiencies.

The level of management with whom it is appropriate to discuss the findings is one that is familiar with the internal control area concerned and that has the authority to take remedial action on any identified deficiencies in internal control.

5.2.2 Communication in writing

HKSA 265 (Clarified) requires that the auditor shall communicate **in writing significant deficiencies and other deficiencies** in internal control identified during the audit to those charged with governance and management at an appropriate level of responsibility on a timely basis.

The **content** of the written communication of significant deficiencies in internal control includes:

- (a) The description of the deficiencies and explanation of their potential effects (no quantification of those effects are needed);
- (b) The written communication of significant deficiencies in internal control should explain:
 - (i) the purpose of the audit was for the auditor to express an opinion on the financial statements;
 - (ii) the consideration of internal control by auditor is not for the purpose of expressing an opinion on the effectiveness of internal control;
 - (iii) the reported deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance;
- (c) Suggestions for remedial action on the deficiencies;
- (d) Management's actual or proposed responses to these deficiencies;
- (e) Verifications whether management's responses have been implemented;
- (f) Regulatory authorities that require the auditor or management to furnish a copy of the auditor's written communication on significant deficiencies;
- (g) The possibility of identifying more deficiencies if more extensive procedures on internal control have been performed;
- (h) Communication for those charged with governance; and
- (i) The relevant industry knowledge and practice in respect of the deficiencies.

The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. The communication of other deficiencies in internal control that merit management's attention need not be in writing, but may be oral.

5.3 Action taken by management and those charged with governance

HKSA
265.A16

Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance.

If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous

communication. Auditors may have to inquire why the significant deficiency has not yet been remedied.

Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. Without remedying the deficiencies, auditors may have further doubt on management's integrity.

Nevertheless, the failure of management to remedy other deficiencies in internal control that have been previously communicated may become a significant deficiency requiring communication with those charged with governance.



Self-test question 4

Lewis (Clothing) Limited (“Lewis”) is a retailer of clothing and accessories. It operates in many Asian countries and has expanded steadily from its base in Hong Kong. The company has a year end of 31 December 20X0.

In the past, the company has ordered its clothing and accessories in bulk twice a year. From experience, slow-moving goods and obsolete goods would be written off if these goods failed to meet the key fashion trends.

The company has recently adopted a just in time ordering system. The fashion purchasers make an assessment one year in advance as to what the key trends are likely to be.

The following describes the purchasing cycle of Lewis:

Ordering process

The purchasing manager from each country decides on the initial inventory levels for each store, without consulting the sales manager or store managers. All the orders are communicated to the central buying department at the head office in Hong Kong. An ordering clerk consolidates all the orders and passes them to the purchasing director to review and authorise.

When the inventories are required to be re-ordered, it is the store manager's responsibility to re-order the goods through the purchasing manager; they are prompted weekly to review inventory levels as although the goods are just in time, it can still take up to at least five weeks for goods to be received in store. All orders must be made through the purchasing manager. The store managers cannot place orders independently. There is no centralised inventory system enabling individual stores to check the availability of an item at other locations. Customers who require a specific item of clothing which is not available in a particular store, have to contact other branches themselves or search through the Lewis's main website.

Goods received and Invoicing

Goods received are delivered directly from the suppliers to the individual stores. Upon receiving the goods, the quantities are checked by the shop's sales assistant against the supplier's delivery note, and then the assistant produces a goods received note (GRN).

The checked GRNs are sent to head office for matching with purchase invoices.

The current system is very time-consuming as purchase invoices are manually checked with the GRNs from the stores. Once the invoice has been agreed then it is sent to the purchasing director for authorisation. It is at this stage that the invoice is entered onto the purchase ledger.

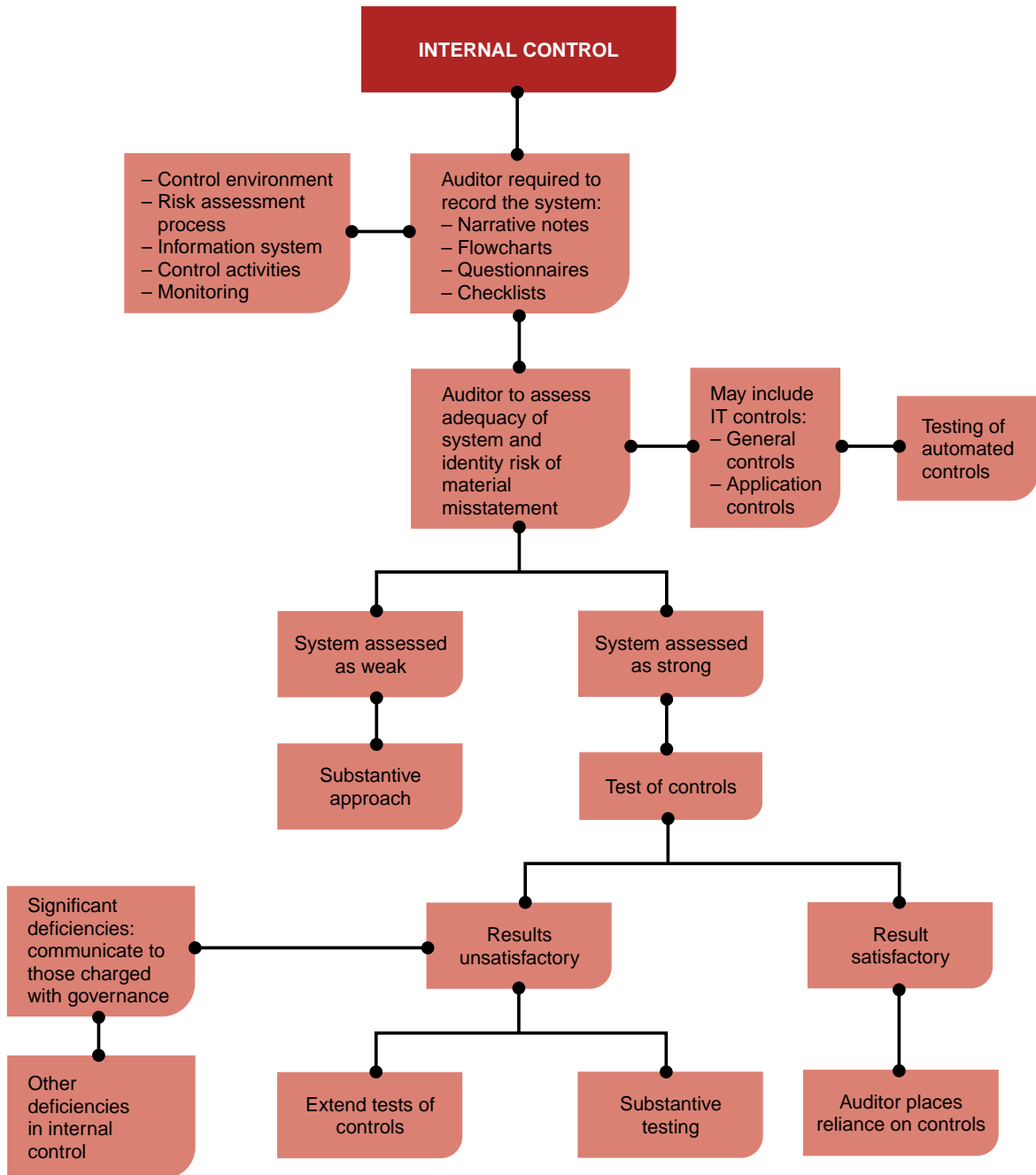
Required

As the external auditors of Lewis, identify and explain the deficiencies in the purchasing system and describe the possible implication of each deficiency. Recommendations should be made to address each deficiency identified.

(16 marks)

(The answer is at the end of the chapter)

Topic recap



Answers to self-test questions

Answer 1

Controls that the company has in place to reduce the risk associated with purchases of food and its preparation in the kitchen, together with relevant audit procedures on controls testing, would include the following:

Controls	Audit Procedures
(i) Overall authority for food purchasing should be in the hands of a designated person to ensure that the food purchased is of the desired quality.	Review the company's organisation chart and identify the person with overall responsibility for food purchasing. Discuss with management his or her background and expertise.
(ii) There should be a list of approved suppliers to ensure that the food comes from sources known for their quality.	Examine the list of approved suppliers of food and check that there are no purchases of food from other parties.
(iii) On receipt of food, whether meat, fish, or vegetables and fruit, it should be carefully inspected by informed people, including those responsible for food preparation. This would be to ensure that it was of the desired quality (as well as quantity). A goods received note (GRN) should be signed to provide evidence of receipt and inspection.	Examine a sample of GRNs to ensure that all bear an approved signature indicating that food has been inspected for quality on receipt.
(iv) Food purchased should be kept in a clean place and refrigerated, if necessary. This would be to ensure that it has kept its quality.	Examine the food storage areas, including refrigerators, on a surprise basis to ensure they are clean and tidy. Ensure that the refrigerators are maintained at the correct temperature. Another test in this area might be to examine reports of local authority and other inspectors to ensure they were happy that the food was being properly stored.
(v) Strict adherence to use-by dates to ensure that no poor quality food is prepared.	Check that there is no food on the premises which is past its use-by date. Discuss with management what happens to food which is past its use-by date, that is, how it is disposed of.

Additionally someone in the company should have responsibility for health and safety and should have the relevant training.

Answer 2

Audit objectives, tests of controls and substantive procedures

Objective: Existence: of assets and liabilities such as cash on hand and in the bank, and of the liability to pay staff and the associated tax and social insurance liabilities.

Tests of controls and substantive procedures

Testing controls over the security of cash to ensure that they are operating effectively throughout the relevant period.

Performing cash counts, with reconciliations to the records and observing cash payments to staff, ensuring that appropriate signatures are obtained and that unclaimed cash is promptly re-banked, for example. Making checks on the physical existence of staff to ensure that the related expenses and liabilities are genuine. Checking after date payments to staff and for tax and social insurance contributions.

Objective: Completeness: there are no unrecorded assets or liabilities (such as those noted under “existence”, above) or transactions (such as payroll payments) or undisclosed items (such as unrecorded payroll liabilities).

Tests of controls and substantive procedures

Manually checking the accuracy of payroll calculations to ensure that correct payments and deductions are being made in accordance with approved pay rates and approved deduction rates for tax and social insurance. Reviewing evidence of authorisation controls to ensure that the payroll has already been checked.

Performing starters and leavers tests to ensure that staff are not paid before they join the entity and are not paid after they leave – this involves checking the payroll for two separate periods and examining entries relating to starters and leavers in the intervening period.

Objective: Occurrence: payroll transactions occurred during the relevant accounting period.

Tests of controls and substantive procedures

Performing cut-off tests to ensure that payroll costs incurred during the period have been recorded during the period by examining entries in the payroll records just before and just after the period-end and checking back to source documentation, such as time sheets or clock cards.

Objective: Presentation and disclosure: an item is disclosed and described in accordance with accounting standards and legislation.

Tests of controls and substantive procedures

Reviewing the financial statements with the aid of a disclosure checklist to ensure that disclosure requirements have been met.

Reviewing the overall presentation of payroll transactions and balances.

Answer 3

(a)

Internal control deficiencies	Implications
Order of raw materials is based on prior month's usage and computer generated purchase orders are not reviewed prior to being sent.	Purchase orders could have been sent for raw materials not required or insufficient for production in the current or coming months or raw materials could have been ordered in times of tight cash flows when insufficient funds are available to pay for them. However, this weakness rebounds more on the efficient operation of the entity. It does not have much direct bearing on financial statement assertions, but would in remote cases that the purchase of raw materials is so excessive that it may materially affect the valuation assertions of inventories.
Neither Goods Received Notes ("GRNs") nor purchase orders are numbered.	It will be difficult to follow up unfulfilled orders or account for missing/spoilt documents without numbering. Liability for raw materials orders may have not been recorded in a timely manner.
No checking of goods received inside of boxes to ensure that the product type, quality and quantities are correct.	Records of inventory may not accurately reflect the actual status of inventory on hand.
Lack of procedures if scanning process aborted.	There may be unrecorded items/untimely recording of items.
No records of raw materials held by sub-contractor and no system to follow up any long outstanding raw materials held by sub-contractors.	Raw materials may have to be reclassified as work-in-progress. Valuation of any long outstanding raw materials held by subcontractors may need to be adjusted.

(b) Key tests that CIS auditors should perform are on controls which are difficult to test using manual methods. This will be the most efficient use of their limited time. Given the high level of reliance placed on computer-generated data, controls tested may include those designed to ensure that:

- suppliers and sub-contractors used are selected only from the list of approved suppliers and sub-contractors maintained on the master file;
- codes scanned on goods received match those on the master file; and
- password access is functioning as expected and staff only have access to the functions they need.

Answer 4

Deficiency 1

The purchasing manager decides on the inventory levels for each store without consulting with store or sales managers. The purchasing manager may not have the appropriate knowledge of the local market and the inventories level for a particular store. This may result in inventory lines being purchased which are unpopular with customers and therefore do not sell. In appropriate amounts of inventory may be purchased resulting in stock-outs or high levels of unsold inventory.

The purchasing manager should initially communicate with the local store managers to understand the market needs and sales volumes before placing the orders.

Deficiency 2

The purchasing director reviews and approves the purchase orders in a wholly aggregated manner.

Without the details of the orders, it will be difficult for the purchasing director to assess whether overall the correct buying decisions are being made.

A purchasing senior manager should review the information prepared for each country and discuss with local purchasing managers the specifics of their orders. These should then be authorised and passed to the purchasing director for final review and sign off.

Deficiency 3

The re-ordering process is reliant on the store managers placing an order with the purchasing manager.

As the re-ordering process can take up to five weeks, any delay by the store managers in placing the orders could result in stock-outs, causing loss of income and reputation.

Automatic re-order levels should be set up in the inventory management systems.

Deficiency 4

There is no centralised inventory system connecting all the stores, therefore it is not possible for a store to order goods from other local stores to serve the customers promptly. Instead customers are told to contact the stores themselves, or use the company website.

Customers are less likely to make an effort to contact individual stores themselves and this could result in the company losing out on valuable sales.

A centralised inventory system should be maintained which allows inter-branch transfers between stores.

Deficiency 5

The sales assistants are only instructed to check the suppliers' delivery notes to the actual quantities delivered, without checking the quality. In addition there is no checking procedure for goods received against purchase orders.

The stores are receiving goods without checking that the quantity matches the amount ordered and that the quality is adequate. Inaccurate quantity of goods and poor quality of goods may be accepted. Lewis may receive and pay for goods not ordered.

Deliveries from suppliers should only be accepted when the goods have been checked on arrival for quantity and quality prior to acceptance from the supplier. A responsible official at each store should produce the GRN from the supplier's delivery information.

A copy of the authorised order form should be sent to the store. This should then be checked to the GRN. Once checked the order should be sent to head office and logged as completed. On a regular basis the purchasing clerk should review the order file for any outstanding items.

(Any further deficiency can be suggested)

Exam practice



Control activities

9 minutes

In a recent dialogue with the internal audit, you understand that the internal audit has issued an unsatisfactory report on the bank reconciliation process of your client. The internal audit report indicated that there was significant control deficiency over the cash management process, and that the management processes and controls were not properly exercised by the operation team.

Required

Explain the meaning of control activities and the required procedures relating to control understanding in addressing significant risks.

(5 marks)

HKICPA December 2012 (amended)





chapter 12

Substantive procedures, including analytical procedures

Topic list

1 Substantive procedures

- 1.1 Types of audit tests
- 1.2 Substantive analytical procedures or tests of details or both
- 1.3 External confirmation as substantive audit procedures
- 1.4 Types of substantive testing
- 1.5 Extent of substantive procedures
- 1.6 Timing of substantive procedures
- 1.7 Evaluate the audit evidence obtained

2 Analytical procedures

- 2.1 Analytical procedures as risk assessment procedures
- 2.2 Substantive analytical procedures
- 2.3 Analytical procedures at the overall review stage
- 2.4 Practical techniques

Learning focus

Substantive procedures are designed to ensure that the **balances in the financial statements are not materially misstated**, that is, to detect whether there are any material errors in the financial statements which have not been prevented by the entity's internal controls. Auditors should consider whether they should use analytical procedures as substantive testing or use only tests of details or even a combination of the two.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.09	Audit procedures	3
2.09.07	Explain the types of substantive procedures and the issues in evaluating the results obtained	
2.09.08	Explain what is meant by analytical review and how analytical review procedures are used in an audit	

1 Substantive procedures



Topic highlights

Auditors need to obtain **sufficient appropriate audit evidence** to support the financial statement assertions. Substantive procedures can be used to obtain that evidence.

HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks* requires that auditors shall **design and perform substantive procedures** for each material class of transactions, account balance and disclosure, irrespective of the assessed risks of material misstatement as the risk assessment is judgmental and may not identify all risks of material misstatement and there are always inherent limitations to internal control.

In relation to any assessed risk of material misstatement at the assertion level that is a **significant risk**, the auditor must plan and perform substantive procedures that are **specifically responsive to that risk** in addition to tests of controls. When the approach to a **significant risk** consists of only substantive procedures, those procedures shall include **tests of details**.

1.1 Types of audit tests

HKSA 330.4

Substantive procedures are tests to obtain audit evidence to detect material misstatements in the financial statements at the assertion level. They are generally of two types:

- Substantive analytical procedures; and
- Tests of details of transactions, account balances and disclosures.

The auditor's substantive procedures should include:

- agreeing the financial statements to the underlying accounting records; and
- examining journal entries and other adjustments made during the course of preparing the financial statements.

The auditor should consider the **nature, extent and timing** of substantive procedures.

1.2 Substantive analytical procedures or tests of details or both



Topic highlights

Substantive tests are designed to discover errors or omissions.

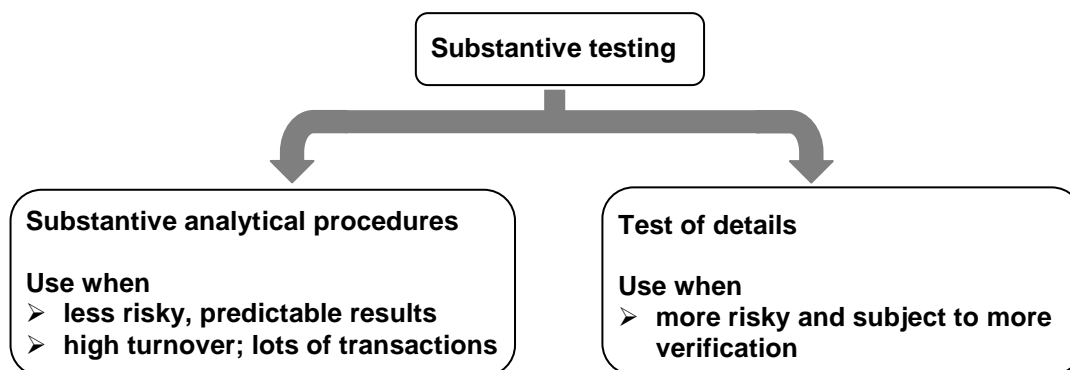
The auditor may determine whether to:

- perform only substantive analytical procedures and consider whether it will be sufficient to reduce audit risk to an acceptably low level;
- perform only tests of details; or
- perform a combination of substantive analytical procedures and tests of details to be most responsive to the assessed risks.

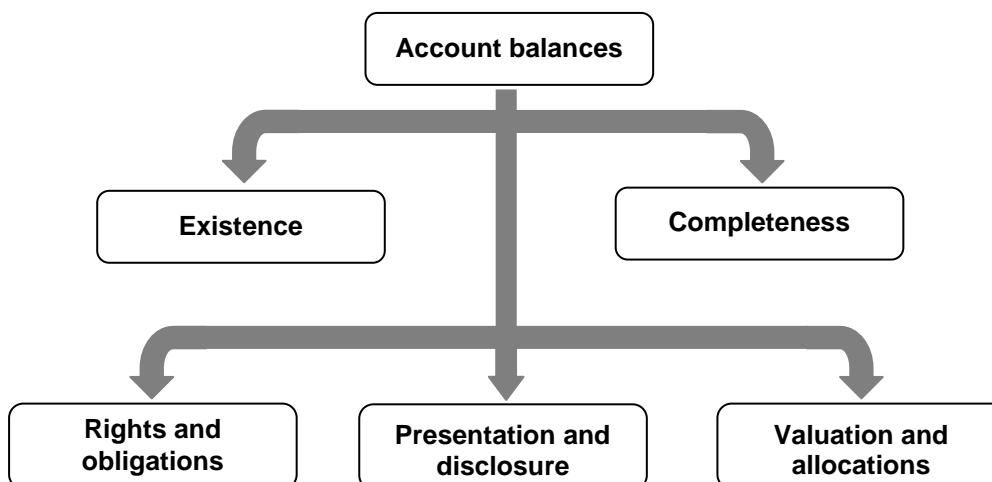
When should auditors use substantive analytical procedures or test of details or should both be used?

The following table demonstrates the application of the two:

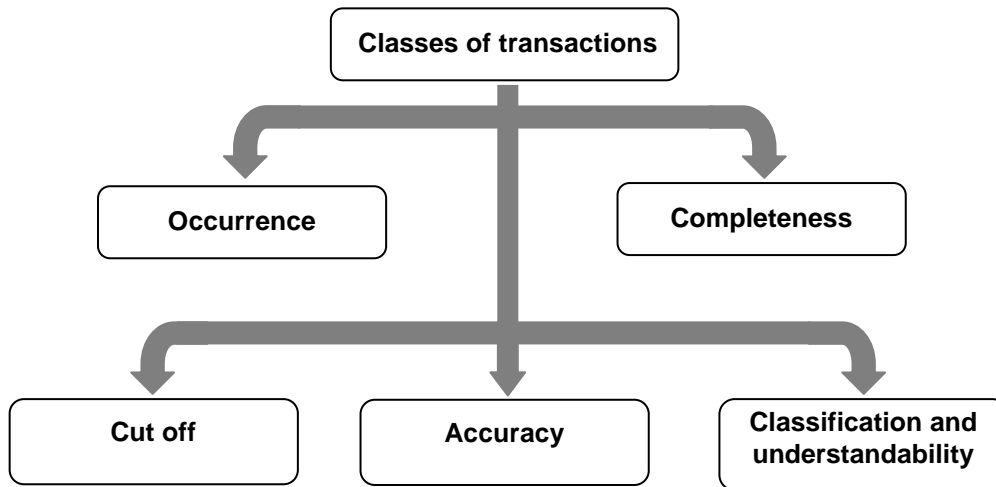
Substantive analytical procedures	<ul style="list-style-type: none"> • More applicable to large volumes of transactions that tend to be predictable over time • Auditors should investigate any unusual items deviated from expectation • Auditors should consider any expected relationships and obtain adequate explanations and appropriate corroborative evidence • Documentation is required • Consider any relationships from known conditions • To apply analytical procedures, information needs to be sufficiently complete and accurate • Should be applied when controls are reliable
Tests of details	<ul style="list-style-type: none"> • For testing certain assertions of classes of transactions and account balances ie existence and valuations • Objective to obtain sufficient and appropriate audit evidence at the assertion level



Substantive testing on statement of financial position's financial assertions



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



1.3 External confirmation as substantive audit procedures

HKSA
330.21, A51

HKSA 330 (Clarified) requires that the auditor shall consider whether **external confirmation** procedures are to be performed as substantive audit procedures.

External confirmations may provide **relevant audit evidence** to some of the assertions. For example, a bank confirmation may request information relevant to other financial statement assertions. However for some assertions, external confirmations provide less relevant audit evidence.

The auditors shall consider the following **factors** to determine whether external confirmation procedures are to be performed as substantive audit procedures:

- The confirming party's **knowledge** of the subject matter to be confirmed
- The **ability or willingness** of the intended confirming party to respond
- The **independence** of the intended confirming party

In addition, factors affecting the **reliability** of confirmations include the following:

- The **control** the auditors exercise over confirmation requests and responses;
- The **characteristics** of the respondents; and
- Any **restrictions** included in the response or imposed by management.

1.3.1 External confirmation for significant risks

External confirmations can provide **high level of reliable** audit evidence to respond to **significant risks** of material misstatement, whether due to fraud or error as the external confirmations are received directly by the auditor and are from appropriate confirming parties.

External confirmations may provide both financial and non-financial audit evidence and could be performed in conjunction with inquiries.

1.4 Types of substantive testing

The types of substantive tests carried out to obtain evidence about various financial statement assertions are outlined in the table below:

Audit assertion	Type of assertion	Typical audit tests
Completeness	Classes of transactions	(a) Review subsequent events
	Account balances	(b) Cut-off testing
	Presentation and disclosure	(c) Analytical review (d) Confirmations (e) Reconciliations to control accounts
Rights and obligations	Account balances	(a) Reviewing invoices for proof that item belongs to the entity
	Presentation and disclosure	(b) Confirmations with third parties
Valuation and allocation	Account balances	(a) Matching amounts to invoices
	Presentation and disclosure	(b) Recalculation
		(c) Confirming accounting policy consistent and reasonable
		(d) Review of post year-end payments and invoices
		(e) Expert valuation
Existence	Account balances	(a) Physical verification
		(b) Third party confirmations
		(c) Cut-off testing
Occurrence	Classes of transactions	(a) Inspection of supporting documentation
	Presentation and disclosure	(b) Confirmation from directors that transactions relate to business
		(c) Inspection of items purchased
Accuracy	Classes of transactions	(a) Recalculation of correct amounts
	Presentation and disclosure	(b) Third party confirmation
		(c) Analytical review
		(d) Valuation by expert
Classification and understandability	Classes of transactions	(a) Confirming compliance with laws and accounting standards
	Presentation and disclosure	(b) Reviewing notes for understandability
Cut-off	Classes of transactions	(a) Cut-off testing
		(b) Analytical review

Use the following model for drawing up an audit plan:

- Agree opening balances with previous year's working papers
- Review general ledger for unusual records
- Agree entity schedules to/from accounting records to ensure completeness
- Carry out analytical procedures
- Test transactions in detail
- Test balances in detail
- Review presentation and disclosure in financial statement

1.5 Extent of substantive procedures

The basic concept is that the **greater the risk of material misstatement**, the greater the extent of substantive procedures is required.

The extent of substantive procedures may depend on the **results from tests of controls** ie if tests of controls are unsatisfactory, the extent may need to be increased. In designing tests of details, the extent of testing is ordinarily related to sample size when using a sampling technique.

The **factors** that the auditor may consider when determining the **sample size** for tests of details:

- (a) Auditor's assessment of the risk of material misstatement. The higher the inherent risk and control risk, the more tests of details have to be performed to reduce the risk of non-detection. Therefore, a larger sample is required.
- (b) Auditor's desired level of assurance. The higher the level of assurance required, the greater the sample size will be.
- (c) The use of other substantive procedures to test the same assertion. An increase in the use of other substantive procedures may reduce the sample size.
- (d) Other factors such as the level of tolerable misstatement and the appropriate use of stratification would affect the sample size.

HKSA 530 (Clarified) *Audit Sampling* requires the auditor when performing tests of details to **project misstatements** found in the sample to the population as a whole to evaluate the results of sampling. When a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population.

The most common **methods of sample selection** which will allow a sample representative of the population are as follows:

- (a) **Random selection** is a sample selection procedures whereby each sampling unit making up the account balance or class transactions has a **known chance** of selection; often each item has an equal chance of selection. The concept of random selection requires that the auditor selecting the samples does not influence or bias the selection either consciously or unconsciously.
- (b) **Systematic selection** involves selecting every *n*th item in the population, the interval being determined by dividing the number of items in the population by the sample size, and selecting a random starting point.
- (c) **Haphazard sampling** involves the auditor selecting sampling units without any conscious bias, and in a manner that can be expected to be representative of the population.

1.6 Timing of substantive procedures

1.6.1 Substantive testing at interim date

HKSA
330.20, 22

The auditor may choose to perform substantive procedures at an interim date and to compare and reconcile information concerning the balance at the period end for any unusual amounts identified.

When the auditor has performed substantive testing at an interim date, the auditor must perform further substantive procedures (possibly in combination with tests of controls) to cover the **remaining period** to provide a reasonable basis for extending the audit conclusions after the interim date. Auditors can use prior year substantive audit evidence only when there is no fundamental change.

For any material misstatements detected at an interim date, HKSA 330 (Clarified) requires that the auditor shall **evaluate** whether he needs to modify the risk assessment and the nature, extent and timing of substantive procedures covering the remaining period.

Auditors can use **prior year** substantive audit evidence only when there is no fundamental change. Generally, audit evidence obtained from the previous audit's substantive procedures provide **little**

or no audit evidence for the current period unless the related subject matter has not fundamentally changed.

1.6.2 Substantive procedures related to the financial statement closing process

HKSA 330 (Clarified) requires that the auditor shall perform the following procedures related to the financial statement closing process:

- (a) Agree and reconcile the financial statements with the underlying accounting records; and
- (b) Examine material journal entries and other adjustments made during the course of preparing the financial statements.

1.7 Evaluate the audit evidence obtained

HKSA
330.24-27

HKSA 330 (Clarified) requires that the auditor shall **evaluate** the audit evidence obtained and consider whether the assessment of risk of material misstatement at the assertion level remains appropriate.

The auditor should conclude whether **sufficient appropriate audit evidence** has been obtained to reduce audit risk to an acceptable low level. Some of the factors that may influence the auditor's judgement as to what constitutes sufficient and appropriate audit evidence, include the following:

- The significance of the potential misstatement in the assertion and the likelihood of its having a material effect on the financial statements both individually or in aggregate
- Source and reliability of the available evidence
- Persuasiveness of the audit evidence
- Effectiveness of management's responses and internal controls to address the risks
- Results of audit procedures performed
- Understanding of the entity and its environment

Further audit evidence should be obtained if the auditor has not obtained sufficient appropriate audit evidence. If still the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should qualify the auditor's report.

1.7.1 Evaluating sampling results for tests of details

Any unexpected high misstatements found in a sample may cause the auditor to believe that a class of transactions or an account balance is materially misstated. The auditor should consider whether the sample results provide a reasonable basis for conclusions about the population and should further consider the likeliness of actual misstatement in the population.

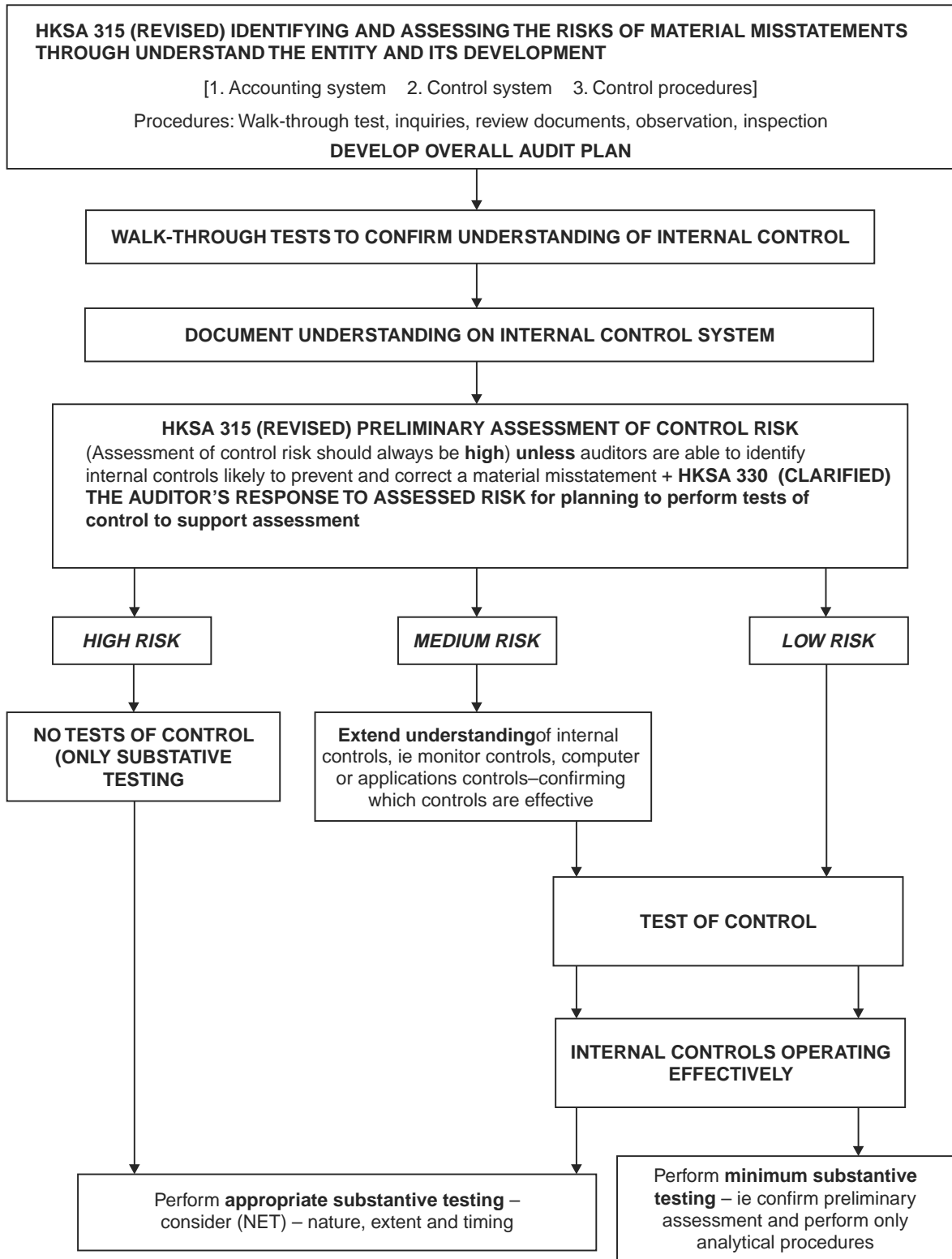
The auditor should consider the results of other audit procedures in order to assess the risk of actual misstatements in the population. The auditor may further request management to investigate the identified misstatements and consider whether management shall make any necessary adjustments. In addition, the auditor shall reconsider the nature, extent and timeliness of further audit procedures.

1.7.2 Evaluation of overall presentation

The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including disclosures, is in accordance with the applicable financial reporting framework an appropriate classification and description of financial information.

The flow chart on the following page illustrates the relationship between tests of control and substantive testing.

You should bear in mind that the chart attempts to generalise and show a simplified depiction of the flow and decision-making points in an audit approach. Audit approaches are bound to differ from client to client in practice, depending on the nature of the business and the nature and level of risk and so on. So the chart below should not be regarded as prescriptive.



2 Analytical procedures



Topic highlights

Analytical procedures are used at all stages of the audit, including as substantive procedures. When using analytical procedures as **substantive tests**, auditors should consider the information available, assessing its **availability**, **relevance** and **comparability**.



Key term

Analytical procedures means evaluations of financial information through analysis of plausible relations among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

HKSA 520.4

HKSA 520.3

The objectives of the auditors as specified in HKSA 520 (Clarified) *Analytical Procedures* are:

- (a) To obtain relevant and reliable audit evidence when using substantive analytical procedures; and
- (b) To design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

According to HKSA 520 (Clarified) analytical procedures include the following:

- (a) Comparisons of data such as:
 - (i) **comparable information** from previous reporting periods
 - (ii) **forecast results** using budgets or estimates
 - (iii) **predictions** extrapolated from current data and their understanding of the entity prepared by the auditors
 - (iv) data derived from wider **industry information**, secondary research and so on
- (b) Ratio analysis to test the relationship of those elements of financial information that are expected to conform to a predicted pattern because of past behaviour. This may be the relationship of gross profit to sales, for example
- (c) Comparing financial information and relevant non-financial information where there should be an obvious link, such as the relationship of payroll expenses to number of employees
- (d) Sensitivity analysis.

Analytical procedures can be used throughout the audit but their use in some circumstances is stated in HKSA 315 (Revised) and HKSA 520 (Clarified) as essential:

- (a) As **risk assessment procedures** to obtain an understanding of the entity and its environment
- (b) Towards the end of the audit to help inform the **overall conclusion** as to the reasonableness of the financial statements assertions.

They may also be used as substantive procedures, either alone or in combination with tests of details.

2.1 Analytical procedures as risk assessment procedures

HKSA 315.6b

HKSA 315 (Revised) requires that the risk assessment procedures shall include analytical procedures as well as inquiries of management and individuals within the internal audit function, observation and inspection. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information and may identify aspects of the entity of which the auditor was **unaware**. The auditor should focus on areas where problems have occurred in past audits and assess the results of developments in the entity's business. The auditor should then design and implement responses to the assessed risks.

However, analytical procedures only provide a **broad initial indication** about whether a material misstatement may exist.

Analytical procedures may help to identify the existence of **unusual** transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. This may assist the auditor in identifying risks of material misstatement, especially **risks of material misstatement due to fraud**.

The auditor can gain **understanding** and evaluate the analytical procedures by considering other information gathered and results of such analytical procedures.

The auditor should obtain from entity the **possible sources of information for analytical procedures** such as:

- entity's interim financial information
- entity's management accounts
- updated budgets
- industry information that is related to entity's business
- relevant information related to current industry conditions
- board minutes
- any external correspondence
- non-financial information

2.2 Substantive analytical procedures

HKSA 520.5

HKSA 520 (Clarified) states that auditors must decide whether using available analytical procedures as substantive procedures in conjunction with tests of details, will be effective and efficient in reducing detection risk for specific financial statement assertions. Auditors may efficiently use analytical data produced by the entity itself, provided they are satisfied that it has been properly prepared. It is based on the auditor's **judgment** to whether to use analytical procedures or not.

The auditor will ordinarily inquire of management about the **availability and reliability** of information needed to apply substantive analytical procedures and the results derived. It may be efficient to use analytical data prepared by the entity, provided the auditor is satisfied that such data is properly prepared.

2.2.1 Factors to consider before performing substantive analytical procedures

When designing and performing substantive analytical procedures, the auditor is required to consider the following factors:

- (a) Determine the **suitability** of particular substantive analytical procedures of certain assertions, ie
 - (i) Auditors will also consider the **plausibility and predictability of the relationships** being tested. Some relationships are strong, for example between selling expenses and sales in business where the salesforce is mainly paid by commission.

- (ii) In general, substantive analytical procedures are more applicable to **large volumes** of transactions that tend to be predictable over time and where **an expectation of relationship** among data exists.
- (b) Develop an expectation of recorded amounts or ratios and evaluate whether the **expectation is sufficiently precise** by considering:
 - (i) the accuracy with which the expected results of substantive analytical procedures can be predicted;
 - (ii) the degree to which information can be disaggregated; and
 - (iii) the availability of financial and non-financial information.
- (c) Evaluate **the reliability of data** from which the auditor's expectation of recorded amounts or ratios is developed. For example:
 - (i) When controls are effective, auditors have greater confidence in the reliability of the information and therefore, in results of analytical procedures;
 - (ii) The **controls over non-financial information** can often be tested in conjunction with tests of **accounting-related controls**. For example, in establishing controls over the processing of sales invoices, a business may include controls over unit sales recording. The auditors could therefore test the controls over the recording of unit sales in conjunction with tests of controls over the processing of sales invoices; and
- (d) Determine the amount of any difference of recorded amounts from expected values that is acceptable without further investigation. This is influenced by:
 - (i) materiality and consistency with the desired level of assurance
 - (ii) the possibility a misstatement may cause the financial statement to be materially misstated
 - (iii) the persuasiveness of audit evidence

According to HKSA 330 (Clarified) when information produced by the entity is used by the auditor in audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information.

2.2.2 Drawing conclusions from substantive analytical procedures

Before drawing any conclusions from substantive analytical procedures, auditors should consider the following factors:

- (a) **Materiality** levels
Auditors **cannot solely** rely on analytical procedures to draw audit conclusions.
- (b) Other audit procedures
Auditors should perform other audit procedures in conjunction with analytical procedures such as performing tests of details – vouching to supporting invoices or tracing to ledger
- (c) Accuracy of expected results of analytical procedures
- (d) Frequency of a relationship – ie consider if there is a monthly pattern or an annual pattern

Analytical procedures are generally **less detailed and less costly** than substantive procedures. However, where internal controls are weak and control risk is high, the auditor may have to rely more on tests of details in order to obtain sufficient, appropriate evidence.

2.2.3 Relationship between assessment of inherent and control risks

Both inherent risk and control risk fall into the category of **risk of material misstatement at assertion level**. HKSA 200 (Clarified) considers both inherent and control risk. No matter how well the internal control system is designed and operated, it can only reduce but not eliminate risks of material misstatements due to inherent limitations.

HKSA often refer to a combined assessment of the “risks of material misstatement” rather than referring to inherent risk and control risk separately. However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations.

2.3 Analytical procedures at the overall review stage

HKSA
520.6, 7

HKSA 520 (Clarified) requires that the auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity.

The auditor shall compare the results of analytical procedures with other corroborate conclusions drawn from other audit procedures. This is intended to assist the auditor in drawing reasonable conclusions for the audit opinion. The results of analytical procedures may lead the auditor to revise his assessment of the risks of material misstatement and modify his audit procedures.

2.3.1 Investigating significant fluctuations or unexpected relationships

According to HKSA 520 (Clarified), when analytical procedures identify significant fluctuations or relationships that are **inconsistent** with other relevant information or that deviate from predicted patterns, the auditor should investigate and obtain adequate explanations and appropriate corroborative evidence.

Investigations will start with **inquiries** of management and then **corroboration** of management’s responses:

- (a) By **comparing** them with the auditors’ knowledge of the entity’s business and with other evidence obtained during the course of the audit; or
- (b) If the analytical procedures are being carried out as substantive procedures, by **undertaking additional audit procedures**, where appropriate, to confirm the explanations received.

If explanations cannot be given by management, or if they are insufficient, the auditors must determine which further audit procedures to undertake to explain the fluctuation or relationship.

2.4 Practical techniques

Ratio analysis can be a useful technique. However, ratios mean very little when used in isolation. They should be calculated for previous periods and for comparable entities. This may involve a certain amount of initial research, but subsequently it is just a matter of adding new statistics to the existing information each year. The permanent file should contain a section with summarised financial statements and the chosen ratios for prior years.

In addition to looking at the more usual ratios the auditors should consider examining other ratios that may be relevant to the particular entity’s business.

Other analytical techniques include the following:

- (a) **Examining related accounts** in conjunction with each other. Often revenue and expense accounts are related to accounts in the statement of financial position and comparisons should be made to ensure relationships are reasonable;
- (b) **Trend analysis.** Sophisticated statistical techniques can be used to compare this period with previous periods; or
- (c) **Reasonableness test.** This involves calculating the **expected value** of an item and comparing it with its actual value, for example, for straight-line depreciation.

$$(\text{Cost} + \text{Additions} - \text{Disposals}) \times \text{Depreciation \%} = \text{Charge in statement of profit or loss and other comprehensive income}$$

Some comparisons and ratios, measuring liquidity and longer-term capital structure, will assist in evaluating whether the entity is a going concern, in addition to contributing to the overall view of the financial statements. Declining ratios may indicate going concern problems.

The working papers must contain the completed results of analytical procedures. They should include:

- the outline **programme** of the work;
- the summary of **significant figures** and relationships for the period;
- a summary of **comparisons** made with budgets and with previous years;
- details of all **significant fluctuations** or **unexpected relationships** considered; and
- details of the **results of investigations** into such fluctuations/relationships.



Self-test question 1

Green Life Limited (“Green”) sells garden furniture from five retail stores. All sales are made either in cash or by credit cards, mainly from customers living in New Territories who have properties with gardens.

All items purchased are delivered to the customer using Green’s own delivery trucks as most customers could not transport these goods in their own motor vehicles. The directors of Green indicate that the company has had a difficult year, but are optimistic to present some acceptable results to the shareholders.

The statements of profit or loss for the last two financial years are shown below:

STATEMENT OF PROFIT OR LOSS

	31 March 20Y0	31 March 20X9
	HK\$'000	HK\$'000
Revenue	7,482	6,364
Cost of sales	<u>(3,520)</u>	<u>(4,253)</u>
Gross profit	3,962	2,111
Operating expenses		
Administration	(1,235)	(1,320)
Selling and distribution	(981)	(689)
Interest payable	(101)	(105)
Investment income	145	-
Profit/(loss) before tax	<u>1,790</u>	<u>(3)</u>
Extract from Statement of Financial Position		
Cash equivalents	<u>253</u>	<u>(950)</u>

Required

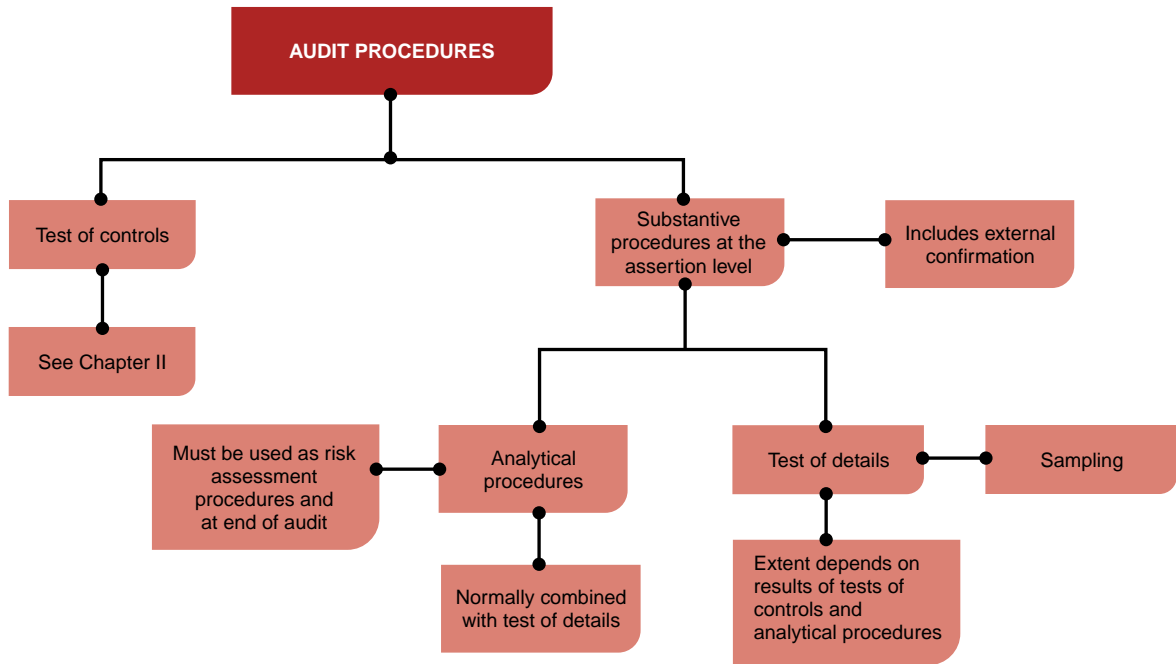
With reference to HKSA 520 *Analytical Procedures* explain the different types of analytical procedures available to the auditor. **(3 marks)**

Using analytical procedures as part of risk assessment procedures for Green, identify and provide a possible explanation for unusual changes in the statement of profit or loss. **(10 marks)**

(Total = 13 marks)

(The answer is at the end of the chapter)

Topic recap



Answer to self-test question

Answer 1

Types of analytical procedures

Under HKSA 520 (Clarified), analytical procedures can be used as:

- Comparison of comparable information to prior periods to identify unusual changes or fluctuations in amounts.
- Comparison of actual or anticipated results of the entity with budgets and/or forecasts, or the expectations of the auditor in order to determine the potential accuracy of those results.
- Comparison to industry information either for the industry as a whole or by comparison to entities of similar size to the client to determine whether receivable days, for example, are reasonable.

Net profit

Overall, Green's result has changed from a net loss to a net profit. Given that sales have only increased by 17% and that expenses, and in particular administration expenses, appear low, then there is the possibility that expenditure may be understated.

Sales – increase 17%

According to the directors, Green has had a “difficult year”. Reasons for the increase in sales income must be ascertained as the change does not appear to agree with the directors' comments. It is possible that the industry as a whole has been growing allowing Green to produce this good result.

Cost of sales – fall 17%

A fall in cost of sales is unusual given that sales have increased significantly. This may have been caused by an incorrect inventory valuation and the use of different (cheaper) suppliers. If quality has been compromised this may cause problems with poor customer satisfaction or faulty goods in the next year.

Gross profit (GP) – increase 88%

This is a significant increase with the GP% changing from 33% last year to 53% in 20Y0. Identifying reasons for this change will need to focus on the change in sales and cost of sales.

Administration – fall 6%

A fall is unusual given that sales are increasing and so an increase in administration to support those sales would be expected.

Expenditure may be understated, or there may have been a decrease in the number of administration staff.

Selling and distribution – increase 42%

This increase does not appear to be in line with the increase in sales – selling and distribution would be expected to increase in line with sales. There may be a mis-allocation of expenses from administration. Alternatively if the age of Green's delivery trucks is increasing this may have resulted in additional service costs.

Interest payable – small fall

Given that Green has a considerable cash surplus this year, continuing to pay interest is surprising. Reasons why this might be the case include the timing of when the surplus cash was generated. Also there may be loans which cannot be repaid early. The amount may be overstated – reasons for lack of fall in interest payments must be determined.

Investment income – new this year

This is expected given the cash surplus at the year end. The amount of investment income does appear high indicating possible errors. Alternatively, there may be other income generating assets not disclosed in the extract of the statement of financial position.

Exam practice



Sources of evidence

22 minutes

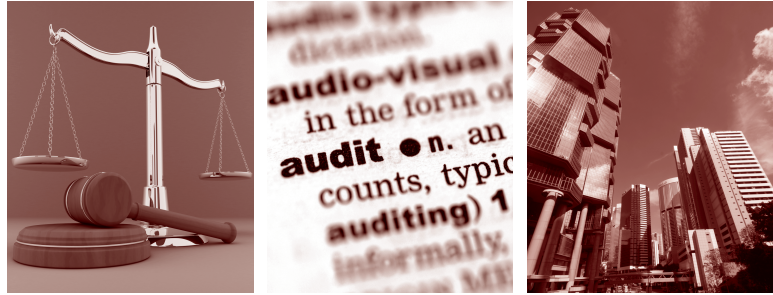
In each of the four following situations, the auditors face two sources of evidence resulting from their audit procedures.

	Source A	Source B
Situation 1	Observation of the client's physical counting of inventories at the year-end.	Confirmation of the client's inventories held at an independent warehouse by requesting a confirmation from the warehouse management.
Situation 2	Observation of the client's inventories composed primarily of sophisticated electronic equipments.	Observation of the client's inventories composed primarily of metal sheets.
Situation 3	Review of all payments made to suppliers after the year-end to determine if they were properly recorded as trade payables at the year-end.	Request for suppliers' confirmations at the year-end for all significant suppliers from which the client made purchases during the year.
Situation 4	Confirmation of the client's bank balance at the year-end direct with the bank.	Checking the balance of the client's bank accounts with bank statements kept by the client.

Required

- (a) For each of the four situations, state the most important financial statement assertion(s) which are being tested by the described audit procedures. **(4 marks)**
- (b) For each of the four situations, identify which of the two sources gives more persuasive evidence, and briefly explain your reasoning. **(8 marks)**

(Total = 12 marks)**HKICPA February 2006 (amended)**



chapter 13

Specific audit procedures

Topic list

- | | |
|---|--|
| <p>1 Tangible non-current assets</p> <p>1.1 Audit objectives for tangible non-current assets</p> <p>1.2 Internal control considerations</p> <p>1.3 Audit procedures for tangible non-current assets</p> <p>1.4 Long-term investments</p> <p>2 Intangible non-current assets</p> <p>2.1 Audit risks in auditing intangible non-current assets</p> <p>2.2 Auditing goodwill, research and development and other intangibles</p> <p>2.3 Auditing the existence and valuation assertions of intangibles</p> <p>3 Inventory</p> <p>3.1 Audit objectives for inventory</p> <p>3.2 Audit procedures for inventory</p> <p>3.3 Physical inventory count</p> <p>3.4 Additional procedures for physical inventory counting conducted other than at the date of the financial statements</p> <p>3.5 Physical inventory count not possible – alternative procedures</p> <p>3.6 Valuation of inventory</p> <p>3.7 Inventory held by third party</p> <p>4 Receivables</p> <p>4.1 The receivables' confirmation</p> <p>4.2 Positive v negative confirmation</p> <p>4.3 Sample selection</p> <p>4.4 Other uses of external confirmations</p> <p>4.5 Follow-up procedures</p> <p>4.6 Evaluation and conclusions</p> <p>4.7 Impairment loss for irrecoverable debt</p> | <p>5 Bank and cash</p> <p>5.1 Bank confirmation procedures</p> <p>5.2 Confirmation requests</p> <p>5.3 Common audit procedures</p> <p>5.4 Auditing cash</p> <p>6 Trade payables and accruals</p> <p>6.1 Audit procedures</p> <p>6.2 Confirmation of trade payables</p> <p>7 Non-current liabilities</p> <p>8 Impairment losses and contingencies</p> <p>8.1 Litigation and claims</p> <p>8.2 Any impairment loss?</p> <p>9 Audit of provisions</p> <p>10 Capital and other issues</p> <p>11 Segment information</p> <p>11.1 Segment information</p> <p>12 Sales</p> <p>12.1 Special sales</p> <p>12.2 Consignment sales</p> <p>13 Purchases</p> <p>13.1 Internal controls</p> <p>13.2 Substantive procedures</p> <p>14 Wages and salaries</p> <p>14.1 Internal controls</p> <p>14.2 Substantive procedures</p> <p>15 Financial instruments</p> <p>15.1 Purposes of HKAPG 1000</p> <p>15.2 Controls relating to financial instruments</p> <p>15.3 Audit considerations relating to financial instruments</p> <p>15.4 Other relevant audit considerations</p> |
|---|--|

Learning focus

In this chapter you will study the audit procedures you would perform to confirm specific assertions in an entity's financial statements. You should understand why a specific procedure is performed. We will examine the substantive audit of trade payables and accruals, long-term liabilities and impairment losses and end with a brief look at capital. Sales are considered in conjunction with trade receivables and purchases are considered in conjunction with the audit of trade payables.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.09	Audit procedures	3
2.09.09	Explain the appropriate audit tests for:	
2.09.09.01	Tangible non-current assets	
2.09.09.02	Intangible non-current assets	
2.09.09.03	Inventory	
2.09.09.04	Receivables	
2.09.09.05	Bank and cash	
2.09.09.06	Trade payables and accruals	
2.09.09.07	Non-current liabilities	
2.09.09.08	Provisions and contingencies	
2.09.09.09	Capital and other issues	
2.09.09.10	Long-term investments	
2.09.09.11	Segment information	
2.09.09.12	Revenue	
2.09.09.13	Purchases	
2.09.09.14	Wages and salaries	
2.09.09.15	Financial instruments	

1 Tangible non-current assets



Topic highlights

These are key areas when testing **tangible non-current assets**:

- **Confirmation** of ownership
- **Inspection** of non-current assets
- **Valuation** by third parties
- **Adequacy** of depreciation rates

1.1 Audit objectives for tangible non-current assets

Financial statement assertion	Audit objective
Existence and occurrence	<ul style="list-style-type: none"> • Additions represent assets acquired in the year and disposals represent assets sold or scrapped in the year • Recorded assets represent those in use at the year-end
Completeness	<ul style="list-style-type: none"> • All additions and disposals that occurred in the year have been recorded • Balances represent assets in use at the year-end
Rights and obligations	<ul style="list-style-type: none"> • The entity has rights to the assets purchased and those recorded at the year-end
Accuracy, classification and valuation	<ul style="list-style-type: none"> • Non-current assets are correctly stated at cost less accumulated depreciation • Additions and disposals are correctly recorded
Assertions relating to presentation and disclosure (occurrence and rights and obligations, completeness, classification and understandability, accuracy and valuation)	<ul style="list-style-type: none"> • Disclosures relating to cost, additions and disposals, depreciation policies, useful lives and assets held under finance leases are adequate and in accordance with accounting standards

1.2 Internal control considerations

The **non-current asset register** is a very important aspect of the internal control system. It enables assets to be identified, and comparisons between the general ledger, non-current asset register and the assets themselves provide **evidence** that the assets are **completely recorded**.

Another significant control is procedures over acquisitions and disposals, that acquisitions and disposals are properly **authorised**, and **proceeds are accounted for**.

Other significant aspects are whether:

- **security arrangements** over non-current assets are **sufficient**
- **non-current assets** are **maintained properly**
- **depreciation** is **reviewed every year**
- **all income** is **collected** from **income-yielding assets**

1.3 Audit procedures for tangible non-current assets

AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS

- | | |
|---------------------|--|
| Completeness | <ul style="list-style-type: none"> • Obtain or prepare a summary of tangible non-current assets showing how: <ul style="list-style-type: none"> – gross book value – accumulated depreciation – net book value reconcile with the opening position. • Compare non-current assets in the general ledger with the non-current assets register and obtain explanations for differences. • For a sample of assets which physically exist agree that they are recorded in the non-current asset register. • If a non-current asset register is not kept, obtain a schedule showing the original costs and present depreciated value of major non-current assets. • Reconcile the schedule of non-current assets with the general ledger. |
| Existence | <ul style="list-style-type: none"> • Confirm that the entity physically inspects all items in the non-current asset register each year. • Inspect assets, concentrating on high value items and additions in-year. Confirm that items inspected: <ul style="list-style-type: none"> – exist – are in use – are in good condition – have correct serial numbers • Review records of income-yielding assets. • Reconcile opening and closing assets by numbers as well as amounts. |
| Valuation | <ul style="list-style-type: none"> • Verify valuation to valuation certificate. • Consider the source of valuation, reviewing: <ul style="list-style-type: none"> – experience of valuer – scope of work – methods and assumptions used – valuation bases are in line with accounting standards • Reperform calculation of revaluation surplus. • Confirm whether valuations of all assets that have been revalued have been updated regularly by inquiries of the Chief Financial Officer and inspection of previous financial statements. • Inspect draft financial statements to check that entity has recognised in the statement of profit or loss and other comprehensive income revaluation losses unless there is a credit balance in respect of that asset in equity, in which case it should be debited to equity to cancel the credit. All revaluation gains should be credited to equity. |

AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS

- **Review depreciation** rates applied in relation to:
 - asset lives
 - residual values
 - replacement policy
 - past experience of gains and losses on disposal
 - consistency with prior years and accounting policy
 - possible obsolescence
- **Review** non-current assets register to ensure that **depreciation** has been **charged on all assets** with a limited useful life.
- Examine depreciation policies and ensure they are correctly and consistently applied in accordance with HKASs.
- Verify that the revaluation of assets is recorded properly.
- For **revalued assets**, ensure that the charge for **depreciation** is based on the revalued amount by recalculating it for a sample of revalued assets.
- **Reperform calculation** of depreciation rates to ensure it is correct.
- **Compare ratios** of depreciation to non-current assets (by category) with:
 - previous years
 - depreciation policy rates
- **Scrutinise** draft financial statements to ensure that **depreciation policies** and rates are **disclosed** in the financial statements.
- **Review insurance policies** in force for all categories of tangible non-current assets and consider the adequacy of their insured values and check expiry dates.

Rights and obligations

- **Verify title** to land and buildings by inspection of:
 - title deeds
 - land registry certificates
 - leases
- Obtain a certificate from lawyers/bankers:
 - **stating purpose** for which the deeds are being held (custody only)
 - **stating deeds** are **free** from **mortgage** or **lien**
- **Inspect registration documents** for vehicles held, confirming that they are in entity's name.
- **Confirm** all vehicles are used for the **entity's business**.
- **Examine documents** of **title** for other assets (including purchase invoices, architects' certificates, contracts, hire purchase or lease agreements).
- **Review for evidence** of charges in statutory books and by company search.

AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS

- **Review leases** of leasehold properties to ensure that entity has fulfilled covenants therein.
- **Examine invoices received after year-end, orders and minutes** for evidence of capital commitments.

Additions

These tests are to confirm **rights and obligations, valuation and completeness**.

- Verify additions by inspection of architects' certificates, solicitors' completion statements, suppliers' invoices etc.
- **Review** capitalisation of expenditure by examining for non-current assets additions and items in relevant expense categories (repairs, motor expenses, sundry expenses) to ensure that:
 - capital/revenue distinction is correctly drawn
 - capitalisation is in line with consistently applied entity's policy
- **Inspect** non-current asset accounts for a sample of purchases to ensure they have been **properly allocated**.
- Check purchases have been **authorised** by directors/senior management by **reviewing board minutes**.
- Ensure that appropriate **claims** have been made for **grants**, and grants received and receivable have been received, by **inspecting** claims documentations and bank statements.
- Check **additions** have been **recorded** by **scrutinising** the non-current asset register and general ledger.

Disposals

These tests are to confirm **rights and obligations, completeness, occurrence and accuracy**.

- **Verify disposals** with supporting documentation, checking transfer of title, sales price and dates of completion and payment.
- **Recalculate** profit or loss on disposal.
- Check that **disposals** have been **authorised** by reviewing board minutes.
- **Consider** whether **proceeds** are **reasonable**.
- If the asset was **used as security**, ensure **release from security** has been correctly made.

Classification and understandability

- Agree opening balances with prior years.
- **Review** non-current asset disclosures in the financial statements to ensure they meet HKAS 16 *Property, Plant and Equipment* criteria.
- For a sample of **fully depreciated assets**, inspect the register to ensure no further depreciation is charged.
- **Inspect** draft financial statements to ensure that **depreciation policies and rates** are correctly **disclosed**.



Self-test question 1

You are the external auditor of Convenient Motor Limited (“CML”), a Hong Kong listed entity which has a year end 31 March. You have been the auditor since CML's listing. CML has purchased over 70 trucks for hiring to CML's customers for transporting goods. Normally, the hiring time ranges from one week to three months.

In the main, all the vehicles are running anywhere in Hong Kong except when some of them have broken down the vehicles will be returned to CML's car park for repairs. Full details of all vehicles are maintained in a non-current assets register.

CML will receive telephone orders or e-mail orders where the booked truck would be ready for collection the next day. Standard hiring amounts are allocated to each booking depending on the amount of time for which the vehicle is being hired.

The net book value of the trucks is \$37.5 million as at the year end and it represents 35 % of CML's total assets.

Required

Describe the audit procedures the auditor should perform on the net book value of CML's trucks at the year end.

(The answer is at the end of the chapter)

Note that inspection of a building's title deeds does **not** give audit evidence about **existence** and if there is doubt that a building actually exists, the auditors should physically inspect it.

1.4 Long-term investments

When long-term investments are **material** to the financial statements, the auditor should obtain sufficient and appropriate audit evidence regarding their **valuation and disclosure**.

The key audit issues to consider are:

- (a) whether the entity has the **ability to continue to hold the investments** on a long-term basis

Audit procedure: Discuss with management and obtain written representations

- (b) whether **to write down the investments to market values**

Audit procedure: Obtain market quotations and compare with the carrying amounts of the investment

2 Intangible non-current assets



Topic highlights

Key assertions for intangible non-current assets are **existence** and **valuation**.

The key assertions relating to intangibles are **existence** (not so much “do they exist?”, but “are they genuinely assets?”) and **valuation**. They will therefore be audited with reference to criteria laid down in the financial reporting standards. As only purchased goodwill or intangibles with a readily ascertainable market value can be capitalised, **audit evidence should be available** (purchase invoices or specialist valuations). The audit of **amortisation** will be similar to the audit of depreciation.

2.1 Audit risks in auditing intangible non-current assets

It is difficult to audit intangible non-current assets such as intellectual property products. The reasons are as follows:

- (a) It is difficult to identify whether and when there is an identifiable asset that will generate expected future economic benefits.
- (b) It is difficult to determine the cost of the asset reliably as the cost of generating the intangible asset internally may not be distinguishable from the cost of maintaining or enhancing the entity or of running day-to-day operations.
- (c) There is difficulty in auditing the estimates used in determining the amount of expected future economic benefits.

2.2 Auditing goodwill, research and development and other intangibles

AUDIT PLAN: INTANGIBLE NON-CURRENT ASSETS

Goodwill	<ul style="list-style-type: none"> • Agree the consideration to sales agreement by inspection. • Consider whether asset valuation (including assumptions) is reasonable. • Agree that the calculation is correct by recalculation. • Review the impairment test and discuss with management • Ensure valuation of goodwill is reasonable/there has been no impairment not adjusted through discussion with management. • Check purchased goodwill is calculated correctly (it should reflect the difference between the fair value of the consideration given and the aggregate of the fair values of the separable net assets acquired).
Research and development costs	<ul style="list-style-type: none"> • Confirm that capitalised development costs conform to HKAS 38 criteria by inspecting details of projects and discussions with technical managers. • Confirm feasibility and viability by inspection of budgets. • Recalculate amortisation calculation, to ensure it commences with production/is reasonable. • Inspect invoices to verify expenditure incurred on research and development projects.
Other intangibles	<ul style="list-style-type: none"> • Agree purchased intangibles to purchase documentation agreement by inspection. • Inspect specialist valuation of intangibles and ensure it is reasonable. • Review amortisation calculations and ensure they are correct by recalculation.

2.3 Auditing the existence and valuation assertions of intangibles

Substantive procedures should be performed including substantive analytical procedures and tests of details. However, it is difficult to design any meaningful analytical procedures on intangible assets. Therefore, it is more efficient to carry out substantive work mainly consisting of tests of details as detailed in the table below:

Existence and valuation of intangibles	
Existence assertion	<ul style="list-style-type: none"> • Obtain an understanding of the entity's systems and the related intangible assets by reviewing internal documentation prepared by the entity to ensure that the intangible assets exist • Involve experts in ensuring the technical feasibility of the intangible assets • Review past history for the existing intangible assets to ensure that a market exists for the intangible assets • Review subsequent sale and use of the intangible assets • Review the entity's application process of relevant accreditation and review the status of accreditation of all its intangible assets
Valuation and allocation assertion	<ul style="list-style-type: none"> • Review costs capitalised • Vouch to source documents to ensure that they are directly attributable to the creation, production and preparation of the intangible assets • Obtain entity's estimates of future economic benefits • Review and test the process used by the entity to develop the estimates • Evaluate data and consider the assumptions on which the estimate is based. For example, by comparing estimates made for prior periods with actual results of those periods • Review entity's approval process for activities, capitalisation of expenses and development of estimates for the intangible assets • Review the appropriateness of entity's estimates in establishing its impairment policy • Review impairment testing and assess the reasonableness of the calculation of a recoverable amount



Self-test question 2

You are the auditor of CC Limited ("CC"). CC acquired DD Limited during the year and recorded goodwill of HK\$300 million and intangible assets such as trade mark, patent and customer relationships of HK\$500 million. Management of CC engaged X Limited to value the intangible assets and advise on the business valuation of the transaction. Based on the business valuation performed by X Limited, CC developed its goodwill impairment assessment and concluded that no goodwill impairment is necessary.

Required

- (a) Evaluate and explain the risk of material misstatement relating to the valuation assertion of CC Limited's goodwill and intangible assets.
- (b) Suggest and discuss the audit procedures you would perform on goodwill and intangible assets respectively in response to the assessed risk of material misstatement in part (a).

(The answer is at the end of the chapter)

3 Inventory



Topic highlights

There are five key assertions relating to inventory:

- **Existence**
- **Completeness**
- **Rights and obligations**
- **Valuation**
- **Cut-off**

Inventory is often a major area of importance for the auditor and, historically, has been the component of the statement of financial position that creates more problems than any other. There are a number of reasons for this including the reasons stated below:

- Inventory is usually a significant balance in the calculation of profit and a material component of the statement of financial position;
- The determination of year-end quantities can be problematic;
- There are different approaches to its valuation and estimation and subjective assessment is usually required; and
- There is an increased risk of manipulation and fraud by management and relevant parties.

3.1 Audit objectives for inventory

The following table demonstrates the audit objectives for inventory and the related financial statement assertions. The audit procedures described in the remainder of this section are undertaken to provide audit evidence to support these assertions.

Financial statement assertion	Audit objective
Existence and occurrence	<ul style="list-style-type: none"> • Recorded purchases and sales represent inventories bought and sold. • Inventory on the statement of financial position physically exists.
Completeness	<ul style="list-style-type: none"> • All purchases and sales are recorded. • All inventory at year-end is included on the statement of financial position.
Rights and obligations	<ul style="list-style-type: none"> • The entity has rights to inventory recorded in the period and at the year-end.

Financial statement assertion	Audit objective
Accuracy, classification and valuation	<ul style="list-style-type: none"> Costs are accurately determined in accordance with accounting standards. Inventory is recorded at year-end at the lower of cost and net realisable value.
Cut-off	<ul style="list-style-type: none"> All purchases and sales of inventories are recorded in the correct period.
Assertions relating to presentation and disclosure (classification and understandability, completeness, accuracy and valuation)	<ul style="list-style-type: none"> Inventory is properly classified in the financial statements. Disclosures relating to classification and valuation are adequate and in accordance with accounting standards.

3.2 Audit procedures for inventory

The following table sets out audit procedures to test year-end inventory:

AUDIT PLAN: INVENTORY	
Existence	<ul style="list-style-type: none"> Observe the physical inventory count (see Section 3.3 for details).
Completeness	<ul style="list-style-type: none"> Complete the disclosure checklist to ensure that all the disclosures relevant to inventory have been made. Trace test counts to the detailed inventory listing. Where inventory is held in third party locations, physically inspect this inventory or review confirmations received from the third party and match to the general ledger. Compare the gross profit percentage to the previous year or industry data.
Rights and obligations	<ul style="list-style-type: none"> Verify that any inventory held for third parties is not included in the year-end inventory figure by being appropriately segregated during the inventory count. For any “bill-and-hold” inventory (ie where the inventory has been sold but is being held by the entity until the customer requires it), identify such inventory and ensure that it is segregated during the inventory count so that it is not included in the year-end inventory figure. Confirm that any inventory held at third party locations is included in the year-end inventory figure by reviewing the inventory listing. Inquire of management and review any loan agreements and board minutes for evidence that inventory has been pledged or assigned. Inquire of management about warranty obligation issues.

AUDIT PLAN: INVENTORY

Accuracy, classification and valuation

- Obtain a copy of the inventory listing and **agree** the totals to the general ledger.
- **Cast** the inventory listing to ensure it is mathematically correct.
- **Vouch** a sample of inventory items to suppliers' invoices to ensure it is correctly valued.
- Where **standard costing** is used, test a sample of inventory to ensure it is correctly valued.
- For **materials**, agree the valuation of raw materials to invoices and price lists.
- Confirm that an appropriate **basis of valuation** (eg FIFO) is being used by discussing with management.
- For **labour** costs, agree costs to wage records.
- **Review** standard labour costs in the light of actual costs and production.
- **Reconcile** labour hours to time summaries.
- Make **inquiries of management** to ascertain any slow-moving or obsolete inventory that should be written down.
- **Examine prices** at which finished goods have been sold after the year-end to ascertain whether any finished goods need to be written down.
- If significant levels of finished goods remain unsold for an unusual period of time, **discuss** with management and consider the need to make allowance.
- **Compare** the gross profit percentage to the previous year or industry data.
- **Compare** raw material, finished goods and total inventory turnover to the previous year and industry averages.
- **Compare** inventory days to the previous year and industry average.
- **Compare** the current year standard costs to the previous year after considering current conditions.
- **Compare** actual manufacturing overhead costs with budgeted or standard manufacturing overhead costs.

Cut-off

- Note the numbers of the **last Goods Despatched Notes (GDNs) and Goods Received Notes (GRNs)** before the year-end and the **first GDN and GRN** after the year-end and check that these have been included in the correct financial year.

AUDIT PLAN: INVENTORY

Assertions relating to presentation and disclosure

<i>Accuracy</i>	<ul style="list-style-type: none"> Obtain a copy of the inventory listing and cast it, and test the mathematical extensions of quantity multiplied by price. Trace test counts back to the inventory listing. If the entity has adjusted the general ledger to agree with the physical inventory count amounts, agree the two amounts. Where a continuous (perpetual) inventory system is maintained, agree the total on the inventory listing to the continuous inventory records, using computer-assisted auditing techniques (CAATs).
<i>Classification and understandability</i>	<ul style="list-style-type: none"> Review the inventory listing to ensure that inventory has been properly classified between raw materials, work-in-progress and finished goods. Read the notes to the financial statements relating to inventory to ensure they are understandable.
<i>Completeness, accuracy and valuation</i>	<ul style="list-style-type: none"> Review the financial statements to confirm whether the cost method used to value inventory is accurately disclosed. Read the notes to the financial statements to ensure that the information is accurate and properly presented at the appropriate amounts.

3.3 Physical inventory count



Topic highlights

Physical inventory count procedures are vital as they provide evidence which cannot be obtained elsewhere or at any other time about the quantities and conditions of inventories and work-in-progress.

HKSA 501.4

HKSA 501 (Clarified) *Audit Evidence – Specific Considerations for Selected Items* provides guidance to auditors on attending the physical inventory count. It states that where inventory is **material**, auditors must obtain sufficient appropriate audit evidence regarding its **existence** and **condition** by attending the physical inventory count, unless this is impracticable and perform audit procedures over the entity's final inventory records to determine whether they accurately reflect actual inventory count results.

Procedures performed during attendance at physical inventory counting may serve as **tests of control or substantive procedures** depending on the auditor's risk assessment, audit approach and the specific procedures carried out.

It is always **management's responsibility** to ensure inventory figures in the accounts both represent inventory that exists and that is actually owned by the entity.

3.3.1 The inventory count

A business may count inventory by one or a combination of the following methods:

(a) **Physical inventory counts at the year-end**

From the viewpoint of the auditor this is often the best method.

(b) **Physical inventory counts before or after the year-end**

This will provide audit evidence of varying reliability depending on:

- (i) the **length of time** between the physical inventory count and the year-end (the greater the time period, the less the value of audit evidence)
 - (ii) the **business's system of internal controls**
 - (iii) the **quality of records of inventory movements** in the period between the physical inventory count and the year-end
- (c) **Continuous (or perpetual) inventory** where management has a programme of inventory-counting throughout the year (see next sub-section).

3.3.2 Continuous (or perpetual) inventory

If **continuous** inventory counting is used, auditors will verify that management does the following:

- (a) Ensures that all inventory lines are counted **at least once a year**.
- (b) Maintains **adequate inventory records** that are kept up-to-date. Auditors may compare sales and purchase transactions with inventory movements, and carry out other tests on the inventory records, for example, checking casts and classification of inventory.
- (c) Has **satisfactory procedures for inventory counts and test-counting**. Auditors should confirm the inventory count arrangements and instructions are as rigorous as those for a year-end inventory count by reviewing instructions and observing counts.

Auditors will be particularly concerned with **cut-off**, that there are no inventory movements while the count is taking place, and inventory records are updated up until the time of the inventory count.

- (d) **Investigates and corrects all material differences**. Reasons for differences should be recorded and any necessary corrective action taken. All corrections to inventory movements should be **authorised** by a manager who has not been involved in the detailed work. These procedures are necessary to guard against the possibility that inventory records may be adjusted to conceal shortages. Auditors should check that the procedures are being operated.

The audit work when continuous inventory counting is used **focuses on tests of controls** rather than substantive audit work. Nevertheless, the auditor will also need to do some further substantive audit work on completeness and existence at the year-end.

Attendance at an inventory count gives evidence of the **existence** (though not necessarily **ownership**) of inventory and in identifying obsolete, damaged or ageing inventory. It also gives evidence of the **completeness** of inventory, as do the follow-up tests to ensure all inventory sheets were included in the final count.

3.3.3 Planning attendance at inventory count

Before the physical inventory count the auditors should ensure audit **coverage** of the **count** is **appropriate**, and that the entity's **count instructions** have been reviewed.

AUDIT PLAN: PLANNING INVENTORY COUNT

- **Review** of previous year's **arrangements**.
- **Discussion with management** regarding inventory count arrangements and significant changes.
- The **nature** and **volume** of the **inventory**.
- **Risks** relating to inventory.
- **Identification** of **high value items**.
- **Method of accounting** for inventory.
- **Location** of inventory and how it affects inventory control and recording.
- **Internal control** and **accounting systems** to identify potential areas of difficulty.
- How to **ensure** a **representative selection** of **locations, inventory** and **procedures** are covered.
- How to **ensure** sufficient attention is given to **high value items**.
- **Arrangements to obtain** from any **third parties' confirmation** of inventory they hold.
- Consideration of the need for **expert help**.
- **Supervision** by senior staff including senior staff not normally involved with inventory.
- **Tidying** and **marking** inventory to help counting.
- **Restriction** and **control** of the production process and inventory movements during the count.
- **Identification of damaged, obsolete, slow-moving, third party** and **returnable** inventory.
- **Systematic counting** to ensure all inventory is counted.
- Teams of **two counters**, with one counting and the other checking or **two independent counts**.
- **Serial numbering, control** and **return** of all inventory sheets.
- Inventory sheets being **completed** in **ink** and **signed**.
- **Information** to be recorded on the **count records** (location and identity, count units, quantity counted, conditions of items, stage reached in production process).
- Recording of **quantity, conditions** and **stage of production** of **work-in-progress**.
- Recording of last numbers of **goods inwards** and **outwards** records and of internal transfer records.
- **Reconciliation** with **inventory records** and **investigation** and correction of any **differences**.

3.3.4 Attendance at inventory count

During the count the auditors should **check the count** is being carried out according to instructions, carry out **test counts**, and watch for **third party** and **slow moving inventory** and **cut-off problems**.

AUDIT PLAN: ATTENDANCE AT INVENTORY COUNT

- **Observe** whether the **entity's staff** are following instructions as this will help to ensure the count is complete and accurate.
- **Perform test counts** to ensure procedures and internal controls are working properly, ie the application of appropriate control activities.
- **Ensure** that the **procedures** for **identifying damaged, obsolete** and **slow-moving** inventory operate properly; the auditors should obtain information about the inventory's condition, age, usage and in the case of **work-in-progress**, its stage of completion to ensure that it is later valued appropriately.
- **Confirm** that **inventory held** on behalf of **third parties** is separately identified and accounted for so that inventory is not overstated.
- **Conclude** whether the **count** has been **properly carried out** and is sufficiently reliable as a basis for determining the existence of inventories.
- **Consider** whether any **amendment** is necessary to subsequent **audit procedures**.
- **Gain** an **overall impression** of the levels and values of inventories held so that the auditors may, in due course, judge whether the figure for inventory appearing in the financial statements is reasonable.

When carrying out test counts the auditors should select items from the management's count records and from the physical inventory and check one to the other, to confirm the accuracy of the count records. These two-way tests provide evidence for completeness and existence. The auditors should concentrate on high value inventory. If the results of the test counts are not satisfactory, the auditors may request that inventory is recounted.

The auditors' working papers should include:

- details of their **observations and tests**
- the manner in which **points** that are **relevant** and **material** to the inventory being counted or measured have been dealt with by the entity
- instances where the **entity's procedures** have **not been satisfactorily carried out**
- **items for subsequent testing**, such as photocopies of (or extracts from) rough inventory sheets
- **details** of the **sequence of inventory sheets**
- the **auditors' conclusions**

3.3.5 After the inventory count

There are a number of follow up procedures once the inventory count has taken place. Among these are the preparation of a memorandum for the working papers and a summary of the results of the observations, test counts and so on, giving an overall conclusion on the effectiveness of the entity's physical inventory activities and the auditor's satisfaction with them. The table goes into more detail:

AUDIT PLAN: FOLLOWING UP THE INVENTORY COUNT

- **Trace items** that were **test counted** to final inventory sheets.
- **Observe whether all count** records, including consignment inventories if they are held, have been **included** in final inventory sheets.
- **Inspect the final inventory sheets** to ensure they are **consistent with** count records.

AUDIT PLAN: FOLLOWING UP THE INVENTORY COUNT

- **Ensure** that **continuous inventory records** have been **adjusted** to the amounts physically counted or measured, and that the reasons for the differences have been identified.
- **Confirm there is a consistent cut-off** by checking sales invoices and supplier invoices are recorded in the proper period.
- **Review replies** from **third parties** about inventory held by or for them and check all consignment inventory is included in the final valuation and against the detailed records held by the entity.
- **Confirm** the entity's final **valuation** of inventory has been calculated correctly.
- **Follow up queries** and **notify any problems** to management.

3.3.6 Risk factors – existence and valuation

When some of these risk factors appear, they will cause higher risk of material misstatements and the following table shows the risks in relation to the most relevant assertions – **existence and valuation**.

Existence

- Inventories at multi-locations
- Inventories of small size but high value
- Manufactured goods require identification of raw materials, work-in-progress
- Inventories with similar appearance
- Inventories requiring special storage
- Inventories are highly desirable and movable, ie the susceptibility of assets to loss or misappropriation is high. For example, fraudulent schemes may be used to disguise the unaccounted for portion of inventories

Valuation

- Inventories with similar appearance
- Inventories requiring special knowledge to value
- Inventories purchased in bulk – difficult to allocate costs
- Inventories of high value – wrong identification is material error
- Inventories requiring special storage – increased chance of obsolescence
- Inventories with fluctuating net realisable value
- Manufactured goods – allocation of costs

3.4 Additional procedures for physical inventory counting conducted other than at the date of the financial statements

HKSA 501.5

Irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system, the physical inventory counting may be conducted at a date or dates **other than the date of the financial statements**.

HKSA 501 (Clarified) requires the auditor shall additionally perform audit procedures to obtain audit evidence about whether **changes in inventory** between the count date and the date of the financial statements are properly recorded. The auditor could consider the effectiveness of the design, implementation and maintenance of **controls over changes in inventory**.

3.5 Physical inventory count not possible – alternative procedures

3.5.1 Rollback exercise

If physical inventory count on planned date is **not possible**, the auditor should take or observe some physical counts on an **alternative date** and perform, if necessary, other audit procedures on **intervening transactions** (ie rollback). For the rollback, it is necessary to ascertain that entity's records of inventory movements in the intervening period can be readily examined and substantiated. A physical inventory count carried out after the year end could only be possible if such records are available and found to be reliable.

The greater the interval between the financial statement date and the physical count date, the more difficult the inventory rollback exercise will be. A rollback exercise will be highly dependent on the soundness of the internal control system, in particular on inventories, and satisfactory maintenance of inventory records.

Note details of the movement of inventory just prior to, during and after the count so that the accounting for such movements can be checked at a later date. Auditors should assess the overall results of the inventory rollback exercise and conclude whether they provide satisfactory evidence as to the physical existence and conditions of entity's inventories as at the date of the financial statements.

3.5.2 Other alternative procedures

When a physical inventory count (ie due to nature and location of the inventory) is impracticable and a rollback exercise is also not possible, the auditors should perform **other alternative procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory** before considering modifying the auditor's report under HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report* as a result of the scope limitation.

If the nature of work in progress is such that its existence cannot be verified by a physical count then **alternative procedures** may include: examining supporting costing records, work tickets, evidence of purchases and sales and testing the internal controls, as well as physical inspection.

Auditors can also compare the current activity between the physical count date and the date of financial statement to activity of the equivalent period in the preceding year and investigate unusual fluctuations. In addition, auditors can review the sales records and investigate the authenticity of any unusually large sales made in the period prior to the inventory count date.

Auditors can determine whether any inventory is **pledged as collateral** or subject to any liens and inspect the open purchase order file at the end of the reporting period for significant commitments that should be considered for disclosure.

3.6 Valuation of inventory



Topic highlights

The **valuation** and **disclosure** rules for inventory are laid down in HKAS 2 *Inventories*. Inventory should be valued at the **lower** of cost and net realisable value.

The auditor needs to consider the valuation of inventories by reviewing whether:

- the entity has followed HKAS 2 when accounting the value for inventories (ie lower of cost or net realisable value)
- the entity has allocated **the overheads appropriately**
- the entity has applied the method of accounting for inventories consistently

3.6.1 Valuation of manufacturing inventories

(a) **Raw materials**

The auditor should check the value of raw materials by vouching to **suppliers' invoices**.

Standard costs can be used and auditor should check the basis of standards, compare standard costs with actual costs and confirm proper treatment of variances.

(b) **Work-in-progress and finished goods**

The auditor should check on the method used by the entity to value work-in-progress and finished goods, the system of internal control and the reasonableness of the valuation of finished goods and work-in-progress.

The auditor should use analytical procedures.

3.6.2 Identification of slow-moving inventories or obsolete items

Audit procedures should determine whether **slow moving or obsolete items** have been included in inventory. This may be done by the following methods:

- (a) Review the perpetual records (or inventory cards) for slow-moving items.
- (b) Discuss the quality of the inventory (in terms of turnover rate, sales prospect, demand of the market etc) with management.
- (c) Ask questions of production personnel during physical inventory observation about the extent of the use or non-use of inventory items.
- (d) Make observations during the physical inventory of rust, damaged inventory, inventory in unusual locations, and unusual amounts of dust on the inventory.
- (e) Be aware of inventory that is tagged obsolete, spoiled, or damaged, or is set aside because it is obsolete or damaged.
- (f) Examine obsolescence reports, scrap sales, and other records in subsequent periods that may indicate the existence of inventory that should have been excluded from the physical inventory or included at a reduced cost.
- (g) Calculate inventory ratios, by type of inventory if possible, and compare them with previous years or industry standards.

3.7 Inventory held by third party

HKSA 501.8

HKSA 501 (Clarified) requires that if the entity has inventory that is held by third parties or in public warehouses and is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing the following procedures:

- (a) Obtaining **direct confirmation** (HKSA 505 (Clarified) *External Confirmations*) relating to quantities and ownership by writing directly to the custodian
- (b) Perform inspection or other audit appropriate procedures such as:
 - (i) observing **physical counts** of the inventory or arranging for the **third party's auditors** to do so, if practicable
 - (ii) obtaining a report on the adequacy of the third party's internal control
 - (iii) inspecting documentation regarding inventory held by third parties
 - (iv) requesting confirmation from other parties when inventory has been pledged as collateral

Summary of audit procedures for auditing existence and valuation of inventories

Existence

- Consider whether inventories are material in the statement of financial position.
- Perform physical count.
- Assess the independence and competence of the counting team, eg whether entity's staff other than from the warehouse have been sufficiently involved and whether the inventory taking is supervised by an appropriately experienced and qualified staff member.
- Trace items selected from the records to the physical inventory and items selected from the physical inventory to the count records.
- Check from the entity's inventory records to auditor's test data for the location and items to be traced at later stage.
- Perform cut-off procedures on the details of the movement of inventory just prior to, during and after the count.
- Obtain expert confirmation about the identification of specialist inventory.
- For inventories situated at different locations, consider at which locations attendance is appropriate, taking into account the materiality of inventory and the risk of material misstatement at different locations.
- Consider the procedures of recording the inventory count results onto the financial statements.

Valuation

- Obtain a full list of inventory. Recalculate the total gross amount and match the recalculated result to the amount in the statement of financial position.
 - Use sampling to sample some expensive inventories and confirm with experienced staff of entity that the actual type or class of these samples agree with the records.
 - Obtain an independent expert's confirmation about the type or class of the inventories in the sample and their valuation.
 - Investigate entity's inventory accounting policy, particularly that relating to overhead allocation, to consider whether the policy complies with relevant accounting standards. Reperform some overhead cost allocations. Ask entity's management about any deviations from the policy.
 - Trace some inventory items in the inventory sheets back to original purchase invoices to agree the cost.
 - Ask entity's management about the process for identification of obsolete and slow moving inventories.
 - Perform analytical procedures, eg compare finished goods to turnover ratios of current and prior years, to consider whether the inventory holdings are reasonable.
 - Obtain or prepare an inventory ageing analysis.
 - Review subsequent sales and purchases.
 - Trace inventory items to post-year end sales to determine the realisable value of inventory.
 - Reconcile test counts recorded during the physical inventory observation to the inventory listing.
 - Review an analysis of inventory turnover, variances and overheads.
-



Self-test question 3

Gourmet Limited (“Gourmet”) manufactures and distributes canned food for supermarkets and groceries. It operates a perpetual inventory system where accurate records of quantities and costs can be retrieved at any point of time. The sales and purchases transactions are interrelated with this inventory system. No year-end inventory count takes place and production will continue even when there is an inventory count in progress. All the inventories are stored in large warehouses in Hong Kong.

Your firm has been the external auditor for Gourmet for three years. You are now performing the audit of inventories which comprise mainly raw materials and finished goods. Your firm wishes to rely on Gourmet's perpetual inventory system to provide the basis of the figure to be included in the financial statements for inventories.

Your firm does not wish to ask the entity to conduct a year-end inventory count.

Required

Describe the audit tests that you would perform on the perpetual inventory system during the year in order to determine whether to rely on it as a basis for the raw materials and finished goods figures to be included in the financial statements. No work has to be performed on work-in-progress.

(The answer is at the end of the chapter)

4 Receivables



Topic highlights

Existence, completeness and **valuation** are key assertions relating to the audit of receivables.

Audit procedures for receivables are set out in the table below. This covers the audit of sales and prepayments as well as trade receivables. Receivables are often tested in conjunction with sales. The key assertions for sales are **occurrence, completeness and accuracy**.

AUDIT PLAN: RECEIVABLES

Completeness

- Agree the balance from the individual sales ledger accounts to the aged receivables' listing and *vice versa*.
- Match the total of the aged receivables' listing to the sales ledger control account.
- Cast and cross-cast the aged trial balance before selecting any samples to test.
- Trace a sample of shipping documentation to sales invoices and into the sales and receivables' ledger.
- Complete the disclosure checklist to ensure that all the disclosures relevant to receivables have been made.
- Compare the gross profit percentage by product line with the previous year and industry data.
- Compare the level of prepayments to the previous year to ensure the figure is materially correct and complete.

AUDIT PLAN: RECEIVABLES

Existence	<ul style="list-style-type: none"> • Perform a receivables' circularisation on a sample of year-end trade receivables (see Section 4.1 for details of how to undertake the receivables' circularisation). • Follow up all balance disagreements and non-replies to the receivables' confirmation. • Perform alternative procedures for any exceptions and non-replies to the receivables' confirmation. • Review after-date cash receipts by inspecting bank statements and cash receipts documentation. • Examine the customer's account and customer correspondence to assess whether the balance outstanding represents specific invoices and confirm their validity. • Examine the underlying documentation (purchase order, despatch documentation, duplicate sales invoice etc). • Inquire from management explanations for invoices remaining unpaid after subsequent ones have been paid. • Observe whether the balance on the account is growing and if so, find out why by discussing with management.
Rights and obligations	<ul style="list-style-type: none"> • Review bank confirmation for any liens on receivables. • Make inquiries of management, review loan agreements and review board minutes for any evidence of receivables being sold (eg to factors).
Valuation and allocation	<ul style="list-style-type: none"> • Compare receivables' turnover and receivables' days to the previous year and/or to industry data. • Compare the aged analysis of receivables from the aged trial balance to the previous year. • Review the adequacy of the allowance for uncollectable accounts through discussion with management. • Compare the bad debt expense as a percentage of sales to the previous year and/or to industry data. • Compare the allowance for uncollectable accounts as a percentage of receivables or credit sales to the previous year and/or to industry data. • Examine large customer accounts individually and compare to the previous year's balances. • For a sample of old debts on the aged trial balance, obtain further information regarding their recoverability by discussions with management and review of customer correspondence. • For a sample of prepayments from the prepayments' listing, recalculate the amount prepaid to ensure that it has been accurately calculated.

AUDIT PLAN: RECEIVABLES

Cut-off	<ul style="list-style-type: none"> For a sample of sales invoices around the year-end, inspect the dates and compare with the dates of despatch and the dates recorded in the ledger for application of correct cut-off. For sales returns, select a sample of returns documentation around the year-end and trace to the related credit entries. Perform analytical procedures on sales returns, comparing the ratio of sales returns to sales. Review material after-date invoices, credit notes and adjustments and ensure that they are recorded correctly in the relevant financial period.
Classification	<ul style="list-style-type: none"> Take a sample of sales invoices and examine for proper classification into revenue accounts.
Accuracy	<ul style="list-style-type: none"> For a sample of sales invoices, compare the prices and terms to the authorised price list and terms of trade documentation. Test whether discounts have been properly applied by recalculating them for a sample of invoices. Test the correct calculation of tax on a sample of invoices.
Occurrence	<ul style="list-style-type: none"> For a sample of sales transactions recorded in the ledger, vouch the sales invoice back to customer orders and despatch documentation.
Occurrence and rights and obligations	<ul style="list-style-type: none"> Determine, through discussion with management, whether any receivables have been pledged, assigned or discounted and whether such items require disclosure in the financial statements.
Classification and understandability	<ul style="list-style-type: none"> Review the aged analysis of receivables for any large credits, non-trade receivables and long-term receivables and consider whether such items require separate disclosure. Read the disclosure notes relevant to receivables in the draft financial statements and review for understandability.
Accuracy and valuation	<ul style="list-style-type: none"> Read the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

4.1 The receivables' confirmation



Topic highlights

A **confirmation of receivables** is a major procedure, usually achieved by **direct contact** with customers. There are two methods of confirmation: **positive** and **negative**.

4.1.1 Objectives of confirmation

External confirmation is a major substantive test used in the audit of accounts receivable balances.

The external confirmation is a **direct written response to the auditor from a third party**. The auditor **designs and performs such procedures to obtain relevant and reliable audit evidence**. **External confirmations can** satisfy the financial assertions of **existence, completeness and rights and obligations** and in addition can provide audit evidence about the absence of certain conditions. External confirmation will produce audit evidence from each respondent whether the amount owed by them to the entity at the date of confirmation is correct.

HKSA
505.7, 8

From an independent source (external parties), it is **reliable** audit evidence. It would satisfy the criteria of “**appropriate**” for evidence. Therefore, when it is reasonable to expect customers to respond, the auditors should ordinarily plan to obtain direct confirmation of receivables to individual entries in an account balance.

The confirmation of receivables on a test basis should not be regarded as replacing other audit procedures, such as the testing in-depth of sales transactions, but the results may influence the scope of such tests.

4.1.2 External confirmation procedures

HKSA 505 (Clarified) *External Confirmations* requires that the auditor shall maintain control over external confirmation requests when using external confirmation procedures such as:

- determining the information to be confirmed or requested
- selecting the appropriate confirming party
- designing the confirmation requests
- sending the requests including follow-up procedures

4.1.3 Timing of confirmation

Ideally the confirmation should take place immediately after the year-end and hence cover the year-end balances to be included in the statement of financial position. However, time constraints may make it impossible to achieve this ideal.

In these circumstances it may be acceptable to carry out the confirmation **prior to the year-end** provided that confirmation is **no more than three months** before the year-end and internal controls are **strong**.

4.1.4 Management's refusal to allow the auditor to send a confirmation request

Confirmation is essentially an act of the **entity**, who alone can authorise third parties to divulge information to the auditors.

HKSA 505 (Clarified) outlines what the auditors' response should be when management refuses permission for the auditors to contact third parties for evidence. Note that this applies to all such external confirmations, not just trade receivables' confirmations.

If management asks the auditor not to seek the confirmation, the auditor should inquire of management the reasons for the refusal and consider if there are valid reasons for the request and obtain evidence to support this.

If the auditor agrees not to seek external confirmations, **other alternative procedures** should be carried out to obtain sufficient appropriate audit evidence. The auditor should consider the **integrity** of management and possible reasons for **any concealment**.

In addition, the auditor should evaluate the implications of management's refusal especially whether it is related to fraud and the implication on nature, extent and timing of audit procedures. If management's request is unreasonable, this may indicate a **fraud risk factor** that requires evaluation in accordance with HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

If the auditor does not accept the validity of management's request and is prevented from undertaking the confirmations, the auditor shall communicate this with those charged with governance under HKSA 260 (Clarified) *Communication with Those Charged with Governance*. The auditor also shall determine the implications for the audit and the auditor's opinion in accordance with HKSA 705 (Clarified) *Modification to the Opinion in the Independent Auditor's Report*.

4.2 Positive v negative confirmation

When confirmation is undertaken, the method of requesting information from the customer may be either **positive** or **negative**.

4.2.1 Positive confirmation

A positive external confirmation request asks the confirming party to reply to the auditor by either:

- indicating the confirming party's agreement with the given information, or
- by asking the confirming party to provide information

Though a positive confirmation request is expected to provide reliable evidence, there is a risk that a confirming party may reply to the confirmation request without verifying whether the information is correct. The auditor may ask the responding party to fill in the amount or furnish further information.

The positive method is generally preferable as it is designed to encourage definite replies from those contacted. It is normally used when there is a small number of material accounts. However, positive confirmation is more time-consuming and generally results in a lower response rate.

4.2.2 Negative confirmation

Negative confirmation request is a request that the confirming party responds directly to the auditor only if the confirming party **disagrees** with the information provided in the request.

Negative confirmations provide **less persuasive** audit evidence than positive confirmations and the auditor shall not use negative confirmation requests as the sole substantive audit procedure unless **all** the following factors are present:

- The auditor has assessed the risk of material misstatement as low
- The entity has effective internal controls
- The population of items comprises a large number of small accounts
- A very low exception rate is expected
- The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard the requests

Alternatively, in some circumstances, say where there is a small number of large accounts and a large number of small accounts, a combination of both methods may be appropriate.

The statements will normally be prepared by the entity's staff, from which point the auditors, as a safeguard against the possibility of fraudulent manipulation, **must maintain strict control** over the preparation and despatch of the statements.

Precautions must also be taken to ensure that undelivered items are returned, not to the entity, but to the auditors' own office for follow-up by them.

4.3 Sample selection

Auditors will normally only contact a **sample** of accounts receivable. If this sample is to yield a meaningful result it must be based upon a **complete list** of all accounts receivable. In addition, when constructing the sample, the following classes of account should receive special attention:

- **Old, unpaid** accounts
- Accounts **written-off** during the period under review
- Accounts with **credit balances**
- Accounts settled by **round sum payments**
- Accounts with **nil balances**
- Accounts which have been **paid** by the date of the examination

4.4 Other uses of external confirmations

External confirmations can be used in the following situations:

- Confirm bank balances and other information relevant to banking relationships
- Accounts receivable/payable and terms
- Consignment inventories
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investment purchased but not delivered
- Loan balances including terms of repayment and restrictive covenants

HKSA
505.10, 12, 14

4.5 Follow-up procedures

4.5.1 Doubts about the reliability of responses to confirmation requests

There is always some risk regardless of the form of the response. Factors that indicate doubts about the reliability of a response include that it:

- was received by the auditor indirectly
- appeared not to come from the originally intended confirming party ie responses received electronically as it is difficult to identify the sender of information

If the auditor identifies factors that give rise to doubts about the reliability of the response to a confirmation request, the auditor shall obtain **further audit evidence** to resolve those doubts. The auditor may request to **contact** the confirming party and in addition, the auditor shall **evaluate the implications** on the assessment of the relevant risks of material misstatement, including the risk of fraud.

4.5.2 Non-responses



Topic highlights

Non-response is a:

- failure of the confirming party to respond or fully respond, to a positive confirmation request
- confirmation request returned undelivered

HKSA 505 requires the auditor shall perform **alternative audit procedures** to obtain relevant and reliable audit evidence. Though oral response to a confirmation request does not meet the definition of external confirmation, the auditor may request the confirming party to respond in writing directly to the auditor. If the auditor is unable to obtain sufficient and appropriate audit evidence, the auditor shall determine the implications for the audit and consider qualification of auditor's opinion.

In certain situations, the auditor may consider a positive confirmation request is necessary to obtain sufficient appropriate audit evidence especially when:

- the information available to corroborate is only available outside the entity
- specific fraud risk factors prevent the auditor from relying on evidence from the entity

A non-response to a confirmation request may indicate **a previously unidentified risk of material misstatement**.

The auditor may need to **revise** the assessed risk of material misstatement at the assertion level, and modify planned audit procedures.

4.5.3 Exceptions



Key term

HKSA 505.6e

Exceptions are responses that indicate a difference between information requested to be confirmed, or contained in the entity's records, and information provided by the confirming party.

The auditor shall **investigate** exceptions to determine whether or not they are indicative of misstatement or indicative of fraud. Finally, exceptions also may indicate a deficiency or deficiencies in the entity's internal control over financial reporting.

Auditors may use the following table to consider the reasons for exceptions:

Reasons for exceptions

There is a **dispute** between the entity and the customer. The reasons for the dispute would have to be identified, and impairment losses made, if appropriate, against the debt.

Cut-off problems exist, because the entity records the following year's sales in the current year or because goods returned by the customer in the current year are not recorded in the current year. Cut-off testing may have to be extended (see below).

The customer may have sent the **monies before** the year-end, but the monies were **not recorded** by the entity as receipts until **after** the year-end. Detailed cut-off work may be required on receipts.

Monies received may have been posted to the **wrong account** or a cash-in-transit account. Auditors should check if there is evidence of other mis-posting. If the monies have been posted to a cash-in-transit account, auditors should ensure this account has been cleared promptly.

Customers who are also suppliers may **net-off balances** owed and owing. Auditors should check that this is allowed.

Teeming and lading, stealing monies and incorrectly posting other receipts so that no particular customer is seriously in debt is a **fraud** that can arise in this area. If auditors suspect teeming and lading has occurred, detailed testing will be required on cash receipts, particularly on prompt posting of cash receipts.

4.5.4 Unreliable responses

When an auditor concludes that the response of the confirmation is unreliable, the auditor may need to revise the risk of material misstatement at the assertion level and modify planned audit procedures accordingly, in accordance with HKSA 315 (Revised). For instance, an unreliable responses might indicate a fraud risk factor that requires evaluation in accordance with HKSA 240 (Clarified).

4.6 Evaluation and conclusions

HKSA 505 (Clarified) requires that the auditor shall evaluate whether the results of the external confirmation procedures provide relevant and reliable audit evidence, or whether further audit evidence is necessary.

The auditor may categorise such results as follows:

- A non-response
- A response indicating agreement with the information provided in the confirmation request
- A response indicating an exception
- A response deemed unreliable

4.7 Impairment loss for irrecoverable debt

The amount shown in the trade receivables in the statement of financial position should be “Outstanding amount on trade receivable less impairment loss for irrecoverable debt”. It is related to the valuation and allocation assertion. Remember the impairment loss is management's estimate so auditors need to refer to HKSA 540 (Clarified) *Auditing Accounting Estimates, including Fair Value Accounting Estimates and Related Disclosures*.

Specific procedures for auditing the valuation and allocation of trade receivables:

- (a) The auditors should understand, ascertain and evaluate the effectiveness of the internal controls over credit policy and control.
- (b) The auditors should understand and ascertain the ageing of the trade receivable balances.
- (c) Based on the aged analysis of trade receivables as at the reporting date, the auditors could perform analytical procedures, such as comparing the trade receivable turnover with previous years', similar entities, or the industry average.
- (d) The auditors should investigate outstanding trade receivable balances, especially for unusual and/or material amounts, and obtain satisfactory explanation from the entity. Account balances involving related party transactions require special attention.
- (e) The auditors should identify and investigate any account balance exceeding the maximum credit limit and obtain satisfactory explanation from the entity.



Self-test question 4

DEF Trading Limited (“DEF”) is principally engaged in purchasing different types of goods from overseas manufacturers and reselling them to retailers in Hong Kong. Since trade receivables is a material item in the statement of financial position of DEF, Wong & Co. (Wong), DEF's auditor, is planning to use external confirmation to verify the account balance of trade receivables as at 31 March 20X0.

Wong sent out trade receivables confirmation requests to all its major debtors and has received the following replies from four major debtors:

- (i) Debtor A replied, “Sorry, we can't answer your request for confirmation of our account unless you provide details of all outstanding invoices”.
- (ii) Debtor B replied, “Yes, the outstanding balance of HK\$488,000 agreed to our accounting record”. However, Debtor B did not sign the response.
- (iii) Debtor C replied, “The balance of HK\$580,000 was paid on 15 March 20X0.”
- (iv) Debtor D replied, “The amount should be HK\$400,000 because the remaining HK\$300,000 was for goods we received after 31 March 20X0.”

Required

- (a) Evaluate the effectiveness of using external confirmation to obtain relevant and reliable audit evidence at the existence, valuation and completeness assertion level of trade receivables.

(5 marks)

- (b) Design additional audit procedures Wong should perform based on the replies from the following four debtors:
- | | |
|----------------|-----------|
| (i) Debtor A | (2 marks) |
| (ii) Debtor B | (2 marks) |
| (iii) Debtor C | (5 marks) |
| (iv) Debtor D | (3 marks) |
- (Total = 17 marks)

HKICPA December 2010 (amended)

(The answer is at the end of the chapter)

5 Bank and cash



Topic highlights

Bank balances are usually **confirmed directly** with the bank in question.

5.1 Bank confirmation procedures

The audit of bank balances will need to cover **completeness, existence, rights and obligations and valuation**. All of these assertions can be audited directly by obtaining third party confirmations from the entity's banks and reconciling these with the accounting records, having regard to **cut-off**.

This type of audit evidence is valuable because it comes directly from an **independent source** and, therefore, provides greater assurance of reliability than that obtained solely from the entity's own records. The bank confirmation is mentioned as a source of external third party evidence in HKSA 505 (Clarified).

5.2 Confirmation requests



Topic highlights

The **bank confirmation letter** can be used to ask a variety of questions, including queries about outstanding interests, contingent liabilities and guarantees.

The auditors should decide from which bank or banks to request confirmation, having regard to such matters as **size of balance, volume of activity, degree of reliance on internal controls, and materiality** within the context of the financial statements.

The auditors should determine which of the following approaches is the most appropriate in seeking confirmation of balances or other information from the bank:

- **Listing balances** and other information, and requesting confirmation of their accuracy and completeness
- **Requesting details of balances** and other information, which can then be compared with the entity's records

In determining which of the above approaches is the most appropriate, the auditors should weigh the **quality of audit evidence** they require in the particular circumstances against the **practicality** of obtaining a reply from the confirming bank.

Difficulty may be encountered in obtaining a satisfactory response even where the entity submits information for confirmation to the confirming bank. It is important that a response is sought for **all** confirmation requests. Auditors should not usually request a response only if the information submitted is incorrect or incomplete.

5.2.1 Preparation and despatch of requests and receipt of replies

Control over the content and despatch of confirmation requests is the responsibility of the auditors. However, it is necessary for the request to be **authorised** by the entity. Replies should be returned directly to the auditors and to facilitate such a reply, a pre-addressed envelope should be enclosed with the request.

5.2.2 Content of confirmation requests

The form and content of a confirmation request letter will depend on the purpose for which it is required and on local practices.

The most commonly requested information is in respect of balances due to or from the entity on **current, deposit, loan and other accounts**. The request letter should provide the account description number and the type of currency for the account.

It may also be advisable to request information about **nil balances**, and accounts which were **closed** in the twelve months prior to the chosen confirmation date. The entity may ask for confirmation not only of the balances on accounts but also, where it may be helpful, other information, such as the maturity and interest terms on loans and overdrafts, unused facilities, lines of credit/standby facilities, any offset or other rights or encumbrances, and details of any collateral given or received.

The entity and its auditors are likely to request confirmation of **contingent liabilities**, such as those arising on guarantees, comfort letter, bills and so on.

Banks often hold **securities** and other items in safe custody on behalf of customers. A request letter may therefore ask for confirmation of such items held by the bank.

Auditor should state clearly the year end date on the confirmation. The auditors should check that the bank has answered all the questions on the confirmation. If there is no reply, auditor should follow up. Confirmation should be set in a standard form and any additional questions should be attached with the confirmation.

5.2.3 Additional local guidance on bank confirmation requests

Additional local guidance is provided in HKSA 505 (Clarified) Appendix 1, which deals with communication with banks but also applies to confirmations requested of other financial institutions, for example, deposit-taking companies.

The auditor should send bank confirmation requests when the entity's banking activities, including treasury operations, are significant to the audit.

The use of a standard bank request form is considered to be of benefit to both the banks and the auditor for the confirmation or provision of information which is customarily held by banks.

When the auditor requires information of matters not covered by the standard request form, a separate letter would be sent to cover the particular matter.

The auditor will review the bank's reply. The auditor may need to carry out additional tests on matters relating to the entity's banking relationship.

5.2.4 Bank cut-off

Care must be taken to ensure that there is no **window dressing**, by auditing **cut-off** carefully. Window dressing in this context is usually manifested as an attempt to overstate the liquidity of the entity by:

- (a) keeping the cash book open to take credit for **remittances actually received** after the year-end, therefore enhancing the balance at bank and reducing receivables
- (b) **recording cheques paid** in the period under review which are not actually despatched until after the year-end, thus decreasing the balance at bank and reducing liabilities.

5.3 Common audit procedures

AUDIT PLAN: BANK

- **Obtain standard bank confirmations** from each bank with which the entity conducted business during the audit period.
- **Reperform** arithmetic of bank reconciliation.
- **Trace cheques shown as outstanding** from the bank reconciliation to the cash book prior to the year-end and to the **after-date bank statements** and **obtain explanations** for any **large or unusual items** not cleared at the time of the audit.
- **Compare cash book(s)** and **bank statements** in detail for the last month of the year, and **check items outstanding** at the reconciliation date to bank statements.
- **Review bank reconciliation** previous to the year-end bank reconciliation and check that **all items** are **cleared** in the last period or **taken forward** to the year-end bank reconciliation.
- Obtain satisfactory explanations for **all items** in the **cash book** for which there are **no corresponding entries** in the **bank statement** and **vice versa** by **discussion** with finance staff.
- **Verify contra items** appearing in the cash books or bank statements with original entry.
- Verify by **inspecting** paying-in slips that **uncleared bankings** are **paid in** prior to the year-end.
- **Examine all lodgements** in respect of which payment has been refused by the bank; ensure that they are cleared on representation or that other appropriate steps have been taken to effect recovery of the amount due.
- Verify balances per the cash book according to the bank reconciliation by **inspecting** cash book, bank statements and general ledger.
- **Verify the bank balances** with reply to **standard bank letter** and with the **bank statements**.
- **Inspect** the cash book and bank statements before and after the year-end for **exceptional entries** or **transfers** which have a material effect on the balance shown to be in-hand.
- Identify whether any **accounts** are **secured** on the **assets** of the entity by **discussion** with management.
- **Consider** whether there is a **legal right** of **set-off** of overdrafts against positive bank balances.
- Determine whether the bank accounts are **subject** to any **restrictions** by **inquiries** with management.
- **Review draft** financial statements to ensure that disclosures for bank are complete and accurate and in accordance with accounting standards.

5.4 Auditing cash



Topic highlights

Cash balances should be verified if they are **material** or **irregularities** are suspected.

Auditors will be concerned that the cash **exists**, is **complete**, and belongs to the entity (**rights and obligations**) and is stated at the correct **value**.

Where the auditors determine that cash balances are potentially material they may conduct a **cash count**, ideally at the period-end. Rather like attendance at an inventory count, the conduct of the count falls into three phases: planning, the count itself, and follow-up procedures.

Some of the common procedures are as follows:

- **Count cash balances** held and agree to petty cash book or other record:
 - Count all balances simultaneously
 - All counting to be done in the presence of the individuals responsible
 - Inquire into any IOUs or cashed cheques outstanding for a long period of time
- **Obtain certificates** of cash-in-hand from responsible officials.
- **Confirm** that bank and cash **balances** as reconciled above are **correctly stated** in the financial statements.

6 Trade payables and accruals



Topic highlights

The largest figure in **current liabilities** is usually **trade accounts payable** which are generally tested by the comparison of **suppliers' statements** with **purchase ledger accounts**.

6.1 Audit procedures

As with accounts receivable, accounts payable are likely to be a material figure in the statement of financial position of most entities. The tests of controls on the purchases cycle will have also provided the auditors with some assurance as to the completeness of liabilities.

However, when conducting their work on the statement of financial position, auditors should be particularly aware of the risk that an entity may wish to **understate** its **liabilities** in order to improve its liquidity ratios and enhance profits (by understating the corresponding purchases). The auditors will want reasonable assurance therefore that **liabilities** existing at the period end have been **completely** and **accurately recorded**.

For **trade payables**, auditors will seek assurance on the two following points:

- Is there an effective **cut-off** between goods received and invoices received, so that purchases and trade payables are recognised in the correct period?
- Do trade payables represent the actual amounts owed by the entity?

Generally, the inherent risks of material misstatement in completeness of accounts payable would be deemed to be **normal/medium**. If the auditor is satisfied by the entity's internal controls he may reduce the combined risks, (inherent risk and control risk) of material misstatement to low.

Before you look at how the auditors may design and conduct their tests with regards to accounts payable, you need to appreciate why the list of balances is important and how this information is used.

The following table sets out audit procedures to test trade payables and accruals:

AUDIT PLAN: TRADE PAYABLES AND ACCRUALS

Completeness

- From a listing of trade payables **reconcile** the total to the general ledger by casting and cross-casting.
- Consider whether there could be significant unrecorded liabilities by **inquiries of management**; examine post year-end transactions.
- Select a sample of suppliers' statements and **trace** these back to the supplier's accounts.
- Examine files of unmatched purchase orders and supplier invoices for any **unrecorded liabilities**.
- Perform a **confirmation of trade payables** for a sample (see Section 6.2 for details of the trade payables' confirmation).
- Complete the **disclosure checklist** to ensure that all the disclosures relevant to liabilities have been made.
- Perform **comparisons** of the following data to check for reasonableness:
 - Current year balances for trade payables and accruals to the previous year.
 - The amounts owed to a sample of individual suppliers in the trade payables listing to amounts owed to these suppliers in the previous year.
 - The payables' turnover and payables' days to the previous year and industry data.

Existence

- **Vouch** selected amounts from the trade payables listing and accruals schedule to supporting documentation (purchase orders and suppliers' invoices and so on).
- **Reconcile** a selection of suppliers' statements to the relevant suppliers' accounts.
- Perform a **confirmation of trade payables** for a sample.
- Perform **analytical procedures** which compare current period balances to the previous period to test reasonableness. Use ratios to calculate payables' turnover and compare the results to the previous year.

Rights and obligations

- **Vouch** a sample of balances to supporting documentation to obtain audit evidence on rights and obligations.

AUDIT PLAN: TRADE PAYABLES AND ACCRUALS

Valuation and allocation

- **Vouch** selected samples from the trade payables listing and accruals listing to the supporting documentation (purchase orders, minutes authorising expenditure and suppliers' invoices etc).
- Select suppliers' statements and **reconcile** these to the relevant suppliers' accounts.
- For **accruals, recalculate** the amount of the certain accrual to ensure the calculation is correct.

Perform the following comparisons:

- the current period balances for trade payables and accruals to the previous period.
- the amounts owed to a sample of individual suppliers in the trade payables listing to amounts owed to these suppliers in the previous year.
- the payables' turnover and payables' days to the previous year and industry data.

Cut-off

- For a sample, **compare the actual dates** with the dates they were recorded in the ledger to check cut-off has been applied correctly.
- **Test transactions** either side of the period end to determine whether amounts have been correctly recognised.
- **Perform analytical procedures** on purchase returns, by comparing the purchase returns as a percentage of sales or cost of sales to the previous year.

Accuracy

- **Recalculate** the sample of suppliers' invoices to confirm the amounts due are correct.

Occurrence

- For a sample of vouchers, **inspect** supporting documentation such as authorised purchase orders.

Classification and understandability

- **Review** the trade payables listing to identify any large debits (which should be reclassified as receivables or deposits) or long-term liabilities which should be disclosed separately.
- **Review** the disclosure notes on liabilities in the draft financial statements: understandability is important.

Accuracy and valuation

- **Read** the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts.

6.2 Confirmation of trade payables

Confirmation of trade payables is not often used in practice because the auditor can test trade payables by examining **reliable, independent evidence** in the form of suppliers' invoices and suppliers' statements. However, it may be used where an entity's internal controls are weak, and suppliers' statements are available where other internal documentation is not. Confirmation of trade payables provides evidence primarily for the **completeness** assertion.

What confirmations will take place will depend on the auditor's assessment of internal control:

- Where the entity has **strong internal controls** and the auditor has reasonable assurance that all liabilities are recorded, the confirmation will focus primarily, if not entirely, on **large balances**.

- (b) Where the auditor suspects there may be **unrecorded liabilities**, regular suppliers who have **small or zero balances** on their accounts and a sample of **other accounts** will be confirmed in addition to any **large balances**.

Auditors use a **positive confirmation** (referred to as a **blank or zero-balance confirmation**). This means the confirmation **does not state** the amount owed but requires the supplier to provide a detailed statement of the account, including the balance owed at the period end. When the confirmation is received back, the amount must be **reconciled** with the entity's records.

7 Non-current liabilities



Topic highlight

Non-current liabilities are usually authorised by the board and should be clearly documented.

In this section we focus on non-current liabilities such as debentures, loan stock and other loans **repayable** at a date **more than one year after the year-end**.

Auditors will primarily try to determine the following:

- Completeness:** whether all non-current liabilities have been adequately recognised
- Accuracy:** whether interest payable has been calculated correctly and included in the correct accounting period
- Classification and understandability:** whether long-term loans and interest have been correctly disclosed in the financial statements. The risk of material misstatement in classification of bank loans is usually low, since the terms of bank loans are clearly set out in the loan agreements.

The main issue for the auditors is that debenture and loan agreements often stipulate conditions with which the entity must comply, which may mean restrictions on the entity's total borrowings or adherence to specific borrowing ratios.

A minimal level of substantive procedures usually suffices unless there are new loans raised during the reporting period, and tests will consist of substantive analytical procedures and obtaining confirmation from the banks.

AUDIT PLAN: NON-CURRENT LIABILITIES

- Either **obtain or prepare a schedule of loans** outstanding at the reporting date. For each loan information should be given about the name of the lender, the date of the loan, the maturity date, the interest date, the interest rate, the balance at the end of the period and what the terms are regarding security.
- **Compare opening balances** to previous year's records.
- **Test the clerical accuracy** of the analysis.
- **Compare balances** to the **general ledger**.
- **Agree name of lender** etc, to **register of debenture holders** or equivalent (if kept).
- **Trace additions** and **repayments** to **entries** in the **cash book**.
- **Confirm repayments** are in accordance with **loan agreement**.
- **Examine cancelled cheques** and **memoranda of satisfaction** for **loans repaid**.
- **Ascertain** that **borrowing restrictions** imposed by agreements are **not exceeded**.
- **Read signed board minutes** relating to **new borrowings/repayments**.

AUDIT PLAN: NON-CURRENT LIABILITIES

- **Obtain direct confirmation** from **lenders** of the amounts outstanding, accrued interest and what security they hold.
- **Verify interest charged** for the period and the adequacy of accrued interest.
- **Confirm assets charged** have been **entered** in the **register of charges** and **notified** to the **Registrar**.
- **Review any restrictive covenants in loan agreements** and impairment losses relating to default:
 - **Review** any **correspondence** relating to the loan
 - **Review confirmation** replies for non-compliance
 - In the event of a **default**, determine its **effect**, and record findings
- **Review minutes and cash book** to confirm that all **loans have been recorded**.
- **Review draft financial statements** to ensure that **disclosures** for non-current liabilities are correct and in accordance with relevant accounting standards. Elements repayable within one year should be classified under current liabilities.

8 Impairment losses and contingencies



Topic highlight

The accounting treatments for impairment loss and contingencies are complex and involve judgment and this can make them difficult to audit.

Examples of the principal types of contingencies disclosed by entities are:

- **guarantees** (for group entities, of staff pension schemes, of completion of contracts)
- **discounted bills of exchange**
- **uncalled liabilities** on shares or loan inventory
- **lawsuits** or claims pending
- **options** to purchase assets

8.1 Litigation and claims

HKSA
501.10, 11, 12

Part of HKSA 501 (Clarified) *Audit Evidence – Specific Considerations for Selected Items* covers contingencies relating to litigation and legal claims, which represent the major part of audit work on contingencies. Litigation and claims involving the entity may have a **material effect** on the financial statements, and so are required **to be disclosed or accounted for** in the financial statements.

The auditor should carry out procedures in order to **become aware** of any litigation and claims involving the entity which may have a material effect on the financial statements. Such procedures would include the following:

- (a) **Make appropriate inquiries of management and others within the entity** including in-house legal counsel
- (b) **Review** minutes of meetings of those charged with governance and **correspondence** with the entity's lawyers
- (c) **Examine legal expense** accounts
- (d) **Use any information** obtained regarding the entity's business including information obtained from discussions with any in-house legal department

8.1.1 Litigation and claims identified

When litigation or claims have been identified or when the auditor believes they may exist, the auditor should seek **direct communication** with the entity's external legal counsel. This will help to obtain sufficient appropriate audit evidence as to whether potential material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable.

When the auditor determines that the risk of material misstatement is a **significant risk** in which this case relates to litigation and claims, the auditor shall evaluate the design of the entity's related controls and determines whether they have been implemented. The communication may be **in writing** and should be consented by management due to confidentiality.

8.1.2 Letter to the entity's external legal counsel

HKSA 501 (Clarified) discusses the form of the direct communication: communication should be "through a letter of inquiry, **prepared by management** and **sent by the auditor**, requesting the entity's external legal counsel to communicate directly with the auditor".

A letter of **general inquiry** requests the entity's external legal counsel to inform the auditor of:

- any litigation and claims of which counsel is aware
- assessment of the outcome of the litigation and claims
- estimate of the financial implications, including costs

If it is thought unlikely that the entity's external legal counsel will respond appropriately to a general inquiry, **the letter of specific inquiry** should specify the following:

- (a) A list of litigation and claims
- (b) **Management's assessment** of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved
- (c) A request that the **entity's external legal counsel confirm the reasonableness** of management's assessments and provides the auditor with further information if the list is considered by counsel to be incomplete or incorrect

The auditors must consider these matters up to the date of their report and so a further, updating letter may be necessary.

8.1.3 Disagreement between management and the entity's external legal counsel

A **meeting** between the auditors and the entity's external legal counsel may be required, for example where a complex matter arises, or where there is a disagreement between management and the entity's external legal counsel. Such meetings should take place only with the permission of management, and preferably with a management representative present.

8.1.4 Management refuses permission to communicate

HKSA 501 (Clarified) states the auditor shall perform **alternative audit procedures** when law, regulation or any professional body prohibits the entity's external legal counsel from communicating directly with the auditor.

The auditor shall modify the auditor's report in accordance with HKSA 705 (Clarified) by giving limitation on scope or a disclaimer of report in the event of either of the following:

- (a) Management refuses to give the auditor permission to communicate or meet with the entity's external legal counsel **or** the entity's external legal counsel refuses to respond appropriately to the letter of inquiry **or** is prohibited from responding
- (b) Auditor is unable to perform alternative audit procedures in order to obtain sufficient appropriate audit evidence

8.1.5 Written representations

HKSA 501 (Clarified) requires that the auditor shall request management or those charged with governance to provide **written representations** that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor have been:

- accounted for
- disclosed in accordance with the applicable financial reporting framework

8.2 Any impairment loss?

The auditor should consider whether management has recognised any impairment loss in the financial statements for litigation and claims. If not, the auditor should consider whether it is necessary to do so. The auditor should perform audit procedures such as those described in the table below.

AUDIT PLAN: IMPAIRMENT LOSSES/CONTINGENCIES

- **Obtain details** of all **impairment losses** which have been included in the **financial statements** and all **contingencies** that have been disclosed.
- **Obtain a detailed analysis** of all impairment losses showing opening balances, movements and closing balances.
- **Determine** for each material impairment losses whether the entity has a **present obligation** as a result of past events by:
 - **review** of **correspondence** relating to the item
 - **discussion** with the **directors**. Have they created a valid expectation in other parties that they will discharge the obligation?
- **Determine** for each material impairment loss **whether** it is **probable** that a **transfer of economic benefits** will be required to settle the obligation through the following procedures:
 - Checking whether any **payments** have been made in the post year-end period in respect of the item by reviewing after-date cash
 - **Review of correspondence** with solicitors, banks, customers, insurance company and suppliers both pre- and post year-end
 - **Sending a letter** to the **legal counsel** to obtain his views (where relevant)
 - **Discussing** the **position** of similar **past** impairment losses with the directors. Were these impairment losses eventually settled?
 - **Considering** the **likelihood** of **reimbursement**
- **Recalculate** all impairment losses made.
- **Compare** the **amount provided** with any post year-end payments and with any amount paid in the past for similar items.
- In the event that it is not possible to estimate the amount of the impairment loss, check that a **contingent liability** is **disclosed** in the financial statements.
- **Consider** the **nature** of the **entity's business**. Would you expect to see any other eg impairment losses warranties?
- Consider the adequacy of **disclosure** of impairment losses and contingent liabilities in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

9 Audit of provisions



Topic highlight

The key issues in the audit of provisions are existence and valuation.

The approach to auditing provisions is similar to that for the audit of contingencies.

AUDIT PLAN: PROVISIONS/CONTINGENCIES

- **Obtain details** of all **provisions** which have been included in the financial statements.
- **Obtain a detailed analysis** of all **provisions** showing opening balances, movements and closing balances.
- **Determine** for each material provision **whether** the **company** has a **present obligation** as a result of past events by:
 - **review** of **correspondence** relating to the item
 - **discussion** with the **directors**. Have they created a valid expectation in other parties that they will discharge the obligation?
- **Determine** for each material provision **whether** it is **probable** that a **transfer of economic benefits** will be required to settle the obligation by:
 - **checking** whether any **payments** have been **made** in the post balance sheet period in respect of the item.
 - **review of correspondence** with solicitors, banks, customers, insurance company and suppliers both pre and post year end.
 - **sending a letter** to the **solicitor** to obtain their views (where relevant).
 - **discussing** the **position** of similar **past provisions** with the directors. Were these provisions eventually settled?
 - **considering** the **likelihood** of **reimbursement**.
- **Recalculate** all **provisions** made.
- **Compare** the **amount provided** with any post year end payments and with any amount paid in the past for similar items.
- In the event that it is not possible to estimate the amount of the **provision**, check that this **contingent liability** is **disclosed** in the accounts.
- **Consider** the **nature** of the **client's business**. Would you expect to see any other provisions eg warranties?
- Consider adequacy of disclosure of **provisions**.

10 Capital and other issues



Topic highlights

The audit of **share capital and reserves** is mainly concerned with the entity's compliance with legal and regulatory requirements.

The auditor must agree the issued share capital as stated in the financial statements to the total recorded in the **share register**.

Where an entity handles its own registration work an examination of share transfers on a test basis should be performed. Where independent registrars carry out the work on behalf of an entity, the auditors will normally examine the reports submitted by them to the entity, and obtain from them a certificate of the share capital in issue at the period end.

Auditors should carry out careful checks as to whether entities have complied with local legislation regarding the issue or purchase of their own shares. Auditors should take particular care if there are any movements in reserves that cannot be distributed, and should confirm that these movements are **valid**.

AUDIT PLAN: CAPITAL AND RELATED ISSUES

Share equity capital	<ul style="list-style-type: none"> • Agree the authorised share capital with the entity's Articles and Memorandum • Agree any changes to authorised share capital with properly authorised resolutions.
Issue of shares	<ul style="list-style-type: none"> • Verify any issue of share capital or other changes during the year with general and board minutes. • Ensure issue or change is within the terms of the constitution, and directors possess appropriate authority to issue shares. • Confirm that cash or other consideration has been received or receivable(s) is included as called-up share capital not paid.
Transfer of shares	<ul style="list-style-type: none"> • Verify transfers of shares by reference to: <ul style="list-style-type: none"> – correspondence – completed and stamped transfer forms – cancelled share certificates – minutes of directors' meetings • Review the balances on shareholders' accounts in the register of members and the total list with the amount of issued share capital in the general ledger.
Dividends	<ul style="list-style-type: none"> • Agree dividends paid and proposed to authority in minute books and check calculation with total share capital issued to ascertain whether there are any outstanding or unclaimed dividends. • Agree dividend payments with documentary evidence such as the returned dividend warrants. • Check that dividends do not breach the distribution legislation. • Check that imputed tax has been accounted for to the taxation authorities and correctly treated in the financial statements.
Reserves	<ul style="list-style-type: none"> • Agree movements on reserves to supporting authority. • Ensure that movements on reserves do not contravene the legislation and the entity's constitution. • Confirm that the entity can distinguish distributable reserves from those that are non-distributable. • Ensure appropriate disclosures of movements on reserves are made in the entity's financial statements by inspection of the financial statements.

11 Segment information



Topic highlights

The entity may be required or permitted to disclose segment information in the financial statements according to the applicable financial reporting framework.

HKSA 501.13

The auditor is **not** required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a stand alone basis but rather the auditor has responsibility regarding the presentation and disclosure of segment information in relation to the financial statements **taken as whole**.

According to HKSA 501 (Clarified) *Audit Evidence – Specific Considerations for Selected Items*, when segment information is **material** to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its **presentation and disclosure of segment information** in accordance with the applicable financial reporting framework (ie HKAS) by:

- (a) performing analytical procedures or other appropriate audit procedures appropriate in the circumstances;
- (b) obtaining an understanding of the methods used by management in determining segment information; such as:
 - (i) evaluating whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework; and
 - (ii) where appropriate, testing the application of such methods.

Requirement of disclosure of segment information

The entity may be required or permitted to disclose segment information in the financial statements, depending on the applicable financial reporting framework.

The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole.

Non-requirement of expression of opinion

Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a standalone basis.

11.1 Segment information

When obtaining an understanding of the methods used by management in determining segment information and whether such methods are likely to result in disclosure in accordance with the applicable financial reporting framework, auditors can perform or examine the following:

- (a) Sales, transfers and charges between segments, and elimination of inter-segment amounts
- (b) Comparisons with budgets and other expected results, for example, operating profits as a percentage of sales
- (c) The allocation of assets and costs among segments
- (d) Consistency with prior periods, and the adequacy of the disclosures with respect to inconsistencies.

12 Sales



Topic highlights

For verification of sales, auditors have to be aware of special sales and consignment sales.

Sales is a **material figure** in the financial statements where the auditor devotes special attention. In most cases, an auditor would perform analytical review at the beginning in order to predict the relationship of sales in relation with other figures in the financial statements.

The auditor wants to ensure the sales are **completely and accurately recorded**.

For financial statement assertions that are relevant to sales, the auditor would concentrate on: **completeness, accuracy and cut-off**.

The audit procedures are listed below:

AUDIT PLAN: SALES

Completeness

Analytical procedures

- Compare current year's sales level with last year.
- Consider the effect on sales value of changes in quantities sold or products or prices.
- Check the level of goods returned, sales allowances and discounts.
- Calculate the gross profit margin and record the reasons for changes.
- Perform a detailed analysis of the gross profit margin.

Vouching and tracing

- Trace from goods despatch notes or till rolls to sales.
- Ensure sales invoices and despatch notes are all pre-numbered.

Cut-off

- Obtain details of the last serial numbers of despatch notes issued before the commencement of any inventory count.
- Ensure the entity has recorded all movement of inventory within the period.
- Consider the last goods received notes and despatch notes prior to and after the inventory count.
- Observe whether correct cut-off procedures are being followed in the despatch and receiving areas.
- Check invoices and credit notes are dated in the correct period.
- Check invoices and credit notes are posted to the sales ledger and general ledger in the correct period.
- Reconcile entries in sales ledger around the year end to daily batch totals to ensure posting is correct and ensure the liability has been recorded in the correct period.
- Review sales ledger control account around year end for unusual items.
- Review material after-date invoices, credit notes and adjustments.
- Review shipment terms for goods in transit.

AUDIT PLAN: SALES

- Test inventory received and sales after period-end and items in transit.
- Examine sales transactions and supporting documentation for a period before the physical inventory count and determine that goods shipped before the physical inventory count have been included in sales and cost of sales, and that goods included in inventory are not included in sales and cost of sales.
- Determine that inventory received after period-end for which title had passed as of the reporting date was reflected in goods in transit and in accounts payable.
- Determine that recorded goods in transit were received after period-end.

Accuracy

- Cast the additions on invoices and check the pricing calculations.
- Check calculations of discounts.
- Check any purchase tax has been added appropriately.
- Trace any debits in the sales account.
- Review reconciliations of sales ledger control account and investigate on any unusual items.
- Review whether entity is following HKAS, Companies Ordinance, and applies the accounting policies consistently throughout the periods ie consistently following revenue recognition.
- Specific review on sales with higher discount or longer repayment terms is required to ensure that the corresponding sales together with the receivables should be accounted for at fair value in accordance with HKAS 18 *Revenue*, HKAS 39 *Financial Instruments: Recognition and Measurement* and HKFRS 9 *Financial Instruments*.
- Ensure compliance with HKAS 18 *Revenue* which requires that revenue be measured at the fair value of the consideration received or receivable, and the related accounting policies be disclosed in the notes to the financial statements.
- Direct confirmation (positive or negative confirmation) meaning verification of the accuracy from independent third party.
- Check to ensure that the sales have been properly authorised and reviewed.
- Review sales budget and forecast.

12.1 Special sales

Apart from the above procedures that should be performed by auditors for normal sales, the entity may have performed some special sales during the year. Auditors should perform additional procedures as listed below:

- (a) Inquire of entity's management their justification for recognising special sales on delivery to customer

- (b) Evaluate compliance in accordance with HKAS 18 to determine whether they had applied HKAS 18 appropriately in accounting for the special sales
- (c) Inspect, or reperform the procedures to obtain a list of special sales made during the year
- (d) Perform substantive analytical procedures on the list of special sales to determine the completeness and accuracy of the information
- (e) Inspect, or reperform, the calculations of the amounts of (a) special sales made during the year, (b) returned during the year and (c) goods delivered under special sales

12.2 Consignment sales

12.2.1 Risks related to consignment sales

When the entity has consignment sales in the financial statements, the risk of material misstatement will be higher.

Consignment sales recognition would have the following risks:

Completeness

Consignees may not have a good accounting system to report in a timely way to the consignor when the consignment goods are sold to third party customers. As it may take considerable time for the consignees to prepare and provide the consignor with information on the consignment goods that have been sold, a delay may result in the recognition of consignment sales.

Occurrence

Consignment sales may not be properly identified and separated from normal sales. This may result in early recognition of consignment sales at the time when goods are delivered to the consignee even before the risks and rewards associated with the ownership of goods have been substantively transferred to third party customers.

Accuracy

The entity's accounting staff may not be familiar with the relevant accounting standards for revenue accounting and may not be able to apply these correctly to the consignment sales of goods transactions.

12.2.2 Audit procedures on consignment sales

AUDIT PLAN: CONSIGNMENT SALES

- Discuss with local management the internal controls that are in place to:
 - identify the existence of consignment sales
 - ensure proper recognition of consignment sales
- Obtain an understanding of consignor's arrangements for consignment sales by reviewing its consignment sales agreements with major consignees.
- Perform walkthrough tests to confirm the auditors' understanding of the entity's system and perform compliance tests on key internal controls.
- Perform cut-off tests on goods sold by the consignees before and after the year-end.
- Perform an analytical review of the consignees' payables balances and review subsequent payment movement by vouching for relevant supporting documents to note any cut-off errors.
- Review correspondence with consignees, particularly in relation to the consignment sales and/or consignment sales returns and look for any delay in sales recognition.
- Review periodic consigned goods reports provided by the consignees to match the entity's internal documentation. Ensure that any variance found was properly explained.

AUDIT PLAN: CONSIGNMENT SALES

- Review and obtain explanations for any long outstanding receivables by the consignees, which may indicate early recognition of consignment sales.
- Attend an inventory count to ensure the existence of consignment inventories if the amount is material. Review the entity's consignment inventory reports and compare them to the inventory count results to ensure the accuracy of the entity's consignment inventory balances.
- Perform direct circularisation to selected consignees for sales transactions balances and consignment inventories balances in any particular time frame to ensure the accuracy of record-keeping between entity and consignees.

13 Purchases



Topic highlights

For verification of purchases, auditors may consider trade payables from the point of directional testing.

The **objectives** for purchases and trade payables imply that:

- goods and services should only be ordered in the correct quantity, quality and at the best terms after appropriate requisition and approval
- all suppliers' invoices should be examined against proper authorised purchase orders
- all goods and services invoiced should be properly recorded in the accounting records on a timely basis
- all purchases and trade payables should be properly classified in the financial statements

13.1 Internal controls

Auditors shall perform tests of controls by searching the following key internal controls:

- Requisition forms** should be pre-numbered and should be approved by authorised persons. Any blank forms should be controlled and recorded and the purchase department should not be allowed to raise purchase requisitions
- Purchase orders** should be pre-numbered and be created only based on approved items of the requisition forms. Again blank form should be controlled and recorded
- Order procedures** should involve tendering and receiving quotations from suppliers
- Sequence checks** of purchase orders should be performed regularly
- Goods received notes and debit notes** should be pre-numbered and should be sent separately to different departments
- Proper controls should be placed on different types of documents such as suppliers' invoices, vouchers and purchase ledgers
- Budgetary techniques** should be used to control all goods and services purchased
- Proper **cut-off procedures** should be established

13.2 Substantive procedures

After obtaining understanding and ascertaining the effectiveness of the internal controls over purchases and trade payables, the auditors shall determine the extent and timing of substantive procedures.

Auditors should check the occurrence, completeness and cut-off assertions for all purchase transactions. Valid reasons should be ascertained for the purchase transactions.

The following are the audit procedures to test the relevant financial statement assertions:

AUDIT PLAN: PURCHASES

Occurrence and completeness

- Perform analytical procedures such as compare the level of purchase and expenses of this year with previous year's level.
- Consider the ratio of trade payable to purchases and the ratio of trade payable to inventory as compared with last year.
- Review the voucher register and purchase ledger for large or unusual items.
- Consider the effect on purchase value of changes in quantities purchased or products or prices.
- Check purchases and other expenses recorded in the purchase or general ledger or cash to supporting documents such as approved requisition forms, goods received notes or suppliers' invoices etc to ensure all the purchases are valid and are allocated to the correct purchase ledger.
- Consider reasonableness of deductions and subsequent events.
- Test the arithmetical accuracy ie by recalculating the amounts on suppliers' invoices, voucher register and purchase ledger.
- Consider any credit balances for purchases.
- Ensure payables are properly measured in accordance with HKAS 39.
- Perform external confirmations for trade creditors' balances.
- Perform procedures to search for unrecorded liabilities.

AUDIT PLAN: PURCHASES

Cut-off

- Check prenumbering of goods received notes before year end to ensure invoices are posted to purchase ledger prior to year end or included in accruals.
- Ensure last year accruals are not expenses again in the current year.
- Check goods returned notes prior to year end.
- Review large invoices credit notes after the year end.
- Review outstanding purchase orders for purchases completed but not invoiced.
- Select goods received notes before and after year-end and check against invoices entered in purchases, inventory and creditor accounts for correct cut-off.
- Perform external confirmations for trade creditors' balances.
- Reconcile entries in sales ledger around the year end to daily batch totals to ensure posting is correct and ensure the liability has been recorded in the correct period.
- Review the control account around the year end for unusual items.

14 Wages and salaries



Topic highlights

Controls testing will normally be a key part of the audit of wages and salaries.

Payroll is an area where misappropriation through fraud is a risk.

14.1 Internal controls

Auditors shall perform tests of controls by searching the following key internal controls:

- (a) Employee records or files should be maintained for each employee ie by the human resources department.
- (b) Employment procedures should be specified and documented ie employing and dismissing an employee.
- (c) Duty reporting records ie time-sheets or clock card records should be maintained.
- (d) Output or piecework records for the employee salaried on their piecework performed should be properly controlled and evidenced.
- (e) A senior officer should be appointed to review independently the payroll records.
- (f) Preparation of payroll should be performed by independent staff who are not involved in employment duties.
- (g) Proper control and documentation are required for check payment, cash payment and direct debits.
- (h) Deductions of Mandatory Provident Fund (MPF) or other pension contributions should be properly reviewed and remitted.
- (i) Independent review and comparison should be performed on a regular and on surprise basis.
- (j) Comparison between the actual and budgeted payroll should be performed regularly.

Other tests of controls that could be done are:

- (a) review payroll costs ie checking authorisation
- (b) attend wages payoff and observe the procedures in operation
- (c) review records of employees

14.2 Substantive procedures

Analytical procedures are a good start to audit wages and salaries, that is, compare this year's figures with last year, consider the wage rate changes and the sales/profits per employee.

For more specific procedures to test the financial statement assertions, please refer to the following:

AUDIT PLAN: WAGES AND SALARIES

Occurrence	<ul style="list-style-type: none"> • Examine personnel records, employment contracts to verify each individual remuneration. • Attend wage payout on an irregular basis. • Investigate long outstanding payroll checks. • Inspect tax records. • Confirm with HR department. • Conduct analytical procedures such as comparing payroll expenses with prior years.
Accuracy	<ul style="list-style-type: none"> • Check calculations of remuneration by re-computing. • Check any deductions from salary such as pension or MPF.
Completeness	<ul style="list-style-type: none"> • Cast check payroll records. • Test commission expenses. • Scrutinise payroll and investigate unusual items. • Agree net pay to payroll ledger.



Self-test question 5

The following are independent situations. All items involved are material.

- (a) The impairment loss for warranty account has a balance of HK\$800,000 which is the same as that of last year.
- (b) A subsidiary engaged in importing has been audited by the Customs and Excise Department which alleges that the entity has been avoiding customs duty on products it is importing. Management has indicated that it disagrees with this contention and will strenuously defend the subsidiary's position. The entity has instructed its external legal counsel to handle the dispute.
- (c) You have sent confirmation requests to four major customers and the responses received are as follows:
 - (i) 'Sorry, can't answer request unless you supply details of all invoices outstanding.'
 - (ii) 'Our balance of amount due to you at 31 December 20Y0 was HK\$170,000. We have paid your invoice dated 15 December 20Y0 of HK\$160,000 last week on 23 February 20Y1. The remaining HK\$10,000 is for your invoice dated 24 December 20Y0. We don't know where your extra HK\$20,000 came from'. (In your client's receivables ledger, the balance at 31 December 20Y0 was HK\$190,000.)
 - (iii) 'Balance agreed to our record' (However, the response was not signed).
 - (iv) 'Our balance due to you at 31 December 20Y0 was HK\$310,000' (In your client's receivables ledger, the balance at 31 December 20Y0 was HK\$200,000.)

Your staff have not performed any other work in this area to date.

Required

In each of the above situations (a) to (c), describe the additional audit procedures you would perform in order to obtain sufficient appropriate audit evidence.

(The answer is at the end of the chapter)

15 Financial Instruments



Topic highlights

“Hong Kong Auditing Practice Guidance” (HKAPG) - **HKAPG 1000 conforms with IAPN 1000** and it provides important practical assistance to auditors when addressing valuation and other considerations pertaining to financial instruments.

Financial instruments may be used by financial and non-financial entities of all sizes for a variety of purposes. Some entities have large holdings and transaction volumes while other entities may only engage in a few financial instrument transactions. Some entities may take positions in financial instruments to assume and benefit from risk while other entities may use financial instruments to reduce certain risks by hedging or managing exposures. This Hong Kong Auditing Practice Guidance (HKAPG) is relevant to all of these situations.

15.1 Purposes of HKAPG 1000

The purpose of the HKAPG1000 is to provide:

- (a) Background information about financial instruments; and
- (b) Discussion of audit considerations relating to financial instruments

HKAPGs provide **practical assistance** to auditors. This HKAPG is relevant to entities of all sizes, as all entities may be subject to risks of material misstatement when using financial instruments.

The guidance on valuation in this HKAPG is likely to be more relevant for financial instruments **measured or disclosed at fair value**, while the guidance on areas other than valuation applies equally to financial instruments either measured at fair value or amortized cost. This HKAPG is also applicable to both **financial assets and financial liabilities**. This HKAPG does not deal with instruments such as:

- (a) The simplest financial instruments such as cash, simple loans, trade accounts receivable and trade accounts payable;
- (b) Investments in unlisted equity instruments; or
- (c) Insurance contracts.

This HKAPG has been written in the context of general purpose fair presentation financial reporting frameworks, but may also be useful, as appropriate in the circumstance, in other financial reporting frameworks such as special purpose financial reporting frameworks.

This HKAPG focuses on the assertions of valuation, and presentation and disclosure, but also covers, in less detail, completeness, accuracy, existence, and rights and obligations.

15.2 Controls relating to financial instruments

Normally, it is the **role of those charged with governance** to set the tone regarding, and approve and oversee the extent of use of, financial instruments while it is management’s role to manage and monitor the entity’s exposures to those risks.

An entity’s **internal control** over financial instruments is more likely to be effective when management and those charged with governance have:

- (a) Established an **appropriate control environment**, active participation by those charged with governance in controlling the use of financial instruments

- (b) Established a **risk management process** relative to the size of the entity and the complexity of its financial instruments
- (c) Established **information systems** that provide those charged with governance with an understanding of the nature of the financial instrument activities and the associated risks, including adequate documentation of transactions
- (d) Designed, implemented and documented a **system of internal control**
- (e) Established **appropriate accounting policies**, including valuation policies, in accordance with the applicable financial reporting framework.

An expectation that controls are operating effectively may be more common when dealing with a financial institution with well-established controls, and therefore controls testing may be an effective means of obtaining audit evidence.

Entities with a high volume of trading and use of financial instruments may have more sophisticated controls, and an effective risk management function, and therefore the auditor may be more likely to test controls in obtaining evidence.

When an entity has relatively few transactions involving financial instruments, it may be relatively easy for the auditor to obtain an understanding of the entity's objectives for using the financial instruments and the characteristics of the instruments.

15.3 Audit considerations relating to financial instruments

Certain factors may make auditing financial instruments particularly challenging:

It may be **difficult** for both management and the auditor to understand the nature of financial instruments.

- Market sentiment and liquidity can change quickly.
- Evidence supporting valuation may be difficult to obtain.
- Individual payments associated with certain financial instruments may be significant, which may increase the risk of misappropriation of assets.
- The amounts recorded in the financial statements relating to financial instruments may not be significant, but there may be significant risks and exposures associated with these financial instruments.

A few employees may exert significant influence on the entity's financial instruments transactions.

These factors may cause risks and relevant facts to be obscured, which may affect the auditor's assessment of the risks of material misstatement. Therefore the auditor needs to use professional scepticism when assessing audit evidence and remain alert for possible indications of management bias.

15.3.1 Planning consideration for auditing financial instruments

The auditor's focus in **planning the audit** is particularly on:

- Understanding the accounting and disclosure requirements;
- Understanding the financial instruments to which the entity is exposed, and their purpose and risks;
- Determining whether specialised skills and knowledge are needed in the audit;
- Understanding and evaluating the system of internal control in light of the entity's financial instrument transactions and the information systems that fall within the scope of the audit;
- Understanding the nature, role and activities of the internal audit function;

- Understanding management's process for valuing financial instruments, including whether management has used an expert or a service organisation; and
- Assessing and responding to the risk of material misstatement.

15.3.2 Assessing and responding to the risks of material misstatement

The use of more **complex** financial instruments, such as those that have a high level of uncertainty and variability of future cash flows, may lead to an increased risk of material misstatement, particularly regarding valuation.

There would also be **fraud risk factors** related to financial instruments, for example:

- Incentives for fraudulent financial reporting by employees may exist where compensation schemes are dependent on returns made from the use of financial instruments.
- Difficult financial market conditions may give rise to increased incentives for management or employees to engage in fraudulent financial reporting: i.e. to protect personal bonuses.
- Misappropriation of assets and fraudulent financial reporting may often involve override of controls.

The auditor's risk assessment process may lead the auditor to identify one or more **significant risks** relating to the valuation of financial instruments, when there are:

- High measurement uncertainties related to the valuation of financial instruments
- Lack of sufficient evidence to support management's valuation of its financial instruments
- Lack of management understanding of its financial instruments or expertise necessary to value such instruments properly
- Lack of management understanding of complex requirements in the applicable financial reporting framework relating to measurement and disclosure of financial instruments
- The significance of valuation adjustments made to valuation technique outputs

15.3.3 Audit procedures on assertions of financial instruments

(a) **Procedures that may provide audit evidence to support the completeness, accuracy, and existence assertions include:**

- External confirmation of bank accounts, trades, and custodian statements.
- Reviewing reconciliations of statements or data feeds from custodians with the entity's own records.
- Reviewing journal entries and the controls over the recording of such entries.
- Reading individual contracts and reviewing supporting documentation of the entity's financial instrument transactions, including accounting records.
- Testing controls, for example by reperforming controls.
- Reviewing the entity's complaints management systems.
- Reviewing master netting arrangements to identify unrecorded instruments.

(b) **Procedures that may provide audit evidence to support the valuation assertion**

The auditor should evaluate whether the valuation techniques used by an entity are appropriate in the circumstances, and whether controls over valuation techniques are in place,

In accordance with HKSA 540 (Clarified), the auditor considers the entity's valuation policies and methodology for data and assumptions used in the valuation methodology.

In testing how management values the financial instrument and in responding to the assessed risks of material misstatement in accordance with HKSA 540 (Clarified), the auditor should:

- Test how management made the accounting estimate and the data on which it is based (including valuation techniques used by the entity in its valuations)
- Evaluate whether the assumptions used by management are reasonable
- Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- Develop a point estimate or a range to evaluate management's point estimate
- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate
- Evaluate the appropriateness of management's expert's work. This assists the auditor in assessing whether the prices or valuations supplied by a management's expert provide sufficient appropriate audit evidence to support the valuations

(c) **Procedures that may provide audit evidence to support the presentation and disclosure assertion**

The auditor's focus may need to be on the disclosures relating to **risks and sensitivity analysis**. Information obtained during the auditor's risk assessment procedures and testing of control activities may provide evidence in order for the auditor to conclude whether or not the disclosures in the financial statements are in accordance with the requirements of the applicable financial reporting framework.

Consideration of the appropriateness of **presentation**, for example on short-term and long-term classification, in substantive testing of financial instruments is relevant to the auditor's evaluation of the presentation and disclosure.

15.4 Other relevant audit considerations

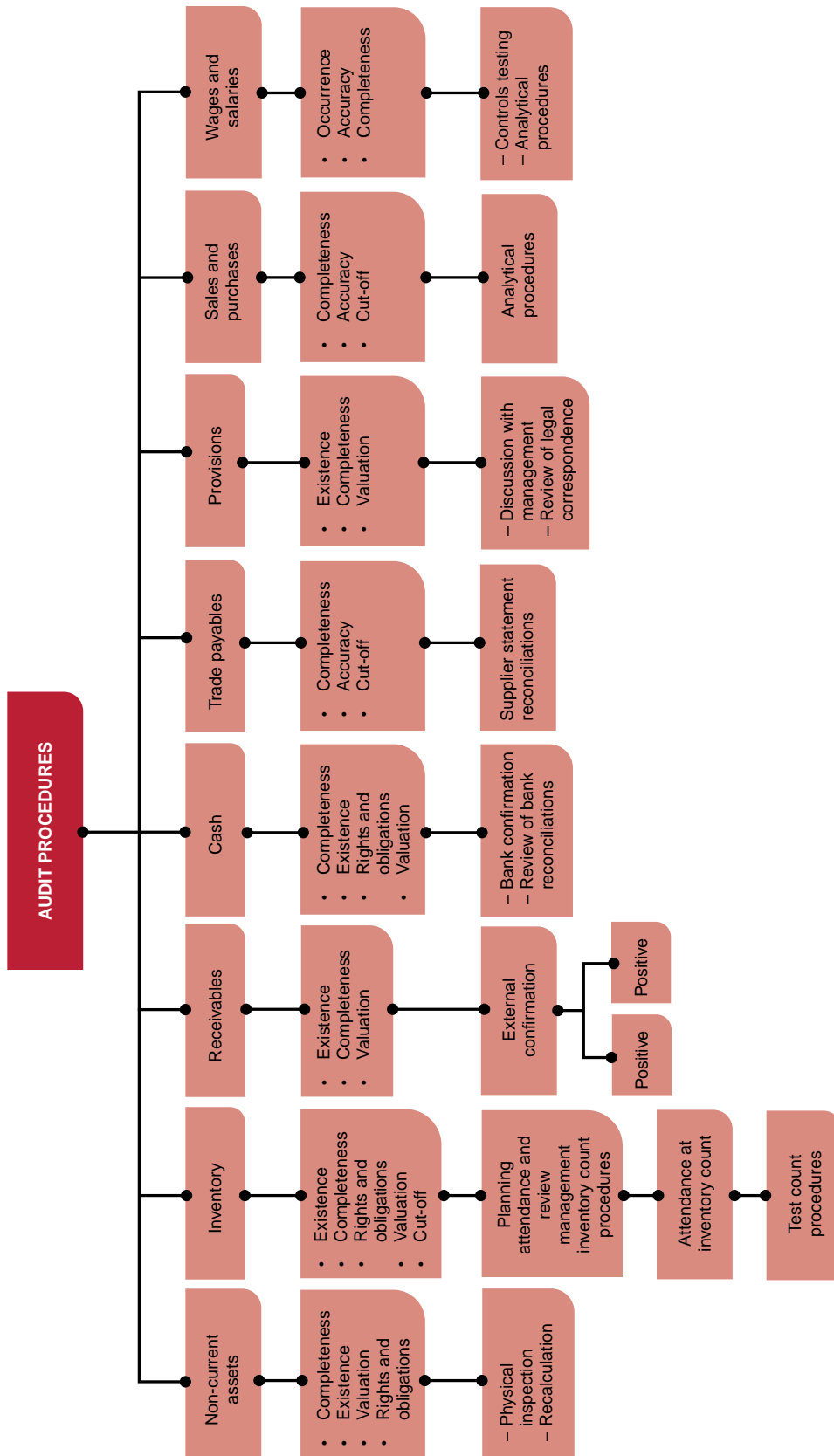
HKSA 580 (Clarified) Written representations

HKSA 540 (Clarified) requires the auditor to obtain **written representations** from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

HKSA 260 (Clarified) Communication with those charged with governance

The auditor may communicate the nature and consequences of **significant assumptions** used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being measured at fair value to the financial statements as a whole. In some cases, auditors may be required, or may consider it appropriate, to communicate directly with regulators or prudential supervisors, in addition to those charged with governance, regarding matters relating to financial instruments.

Topic recap



Answers to self-test questions

Answer 1

Audit work on the trucks

For a sample of new additions in the non-current asset register:

Existence assertion

Agree to the physical asset to confirm existence of the trucks. For trucks out on hire during the audit visit, obtain alternative evidence of existence such as payment from customer near year end for hire or send confirmations.

Check the physical condition of the vehicle to ensure that repairs and renewal expenditure is not being understated (Existence of repair expenditure).

Completeness assertion

For a sample of vehicle purchases during the year, trace details to the non-current assets register.

For a sample of sold/scrapped vehicles during the year, ensure asset has been removed from the non-current assets register.

Valuation assertion

Obtain non-current asset register from entity and cast the cost, depreciation and net book value columns of the register and agree to final figures appearing on the statement of financial position.

Recalculate depreciation in the non-current asset register, ensuring that the rates used are those disclosed in the financial statements.

Review profits and losses generated on sale of vehicles and ensure these are not excessive.

Check the accuracy of the depreciation rates used as this may indicate over or under charge of depreciation.

Rights and obligations assertion

Agree details to purchase invoice or similar document for evidence of ownership ie annual licence.

Occurrence assertion

Examine board minutes or similar documentation for evidence of authority to purchase vehicles.

Compare sales income to sale of similar vehicles with similar mileage and ensure comparable for a sample of disposals during the year.

Check calculation of profit or loss on disposal of trucks.

Agree receipt on sale to the cash book.

Presentation and classification assertion

Agree totals in non-current asset register to the financial statements, ensuring vehicles are disclosed separately in the non-current assets note (material item).

Ensure that the accounting policy for depreciation is clearly stated in the financial statements and is the same as last year.

Answer 2

- (a) The valuation of goodwill and intangible assets may be materially misstated if:
- improper business and intangible asset valuation prepared by X Limited due to wrong assumptions, business data and valuation methodology used;
 - certain intangible assets are not identified from the acquisition;
 - useful lives of the intangible assets are over-estimated; and
 - goodwill impairment assessment was not properly prepared by management with reference to inappropriate business data and assumptions.
- (b) CC Limited's auditor should consider the below audit procedures on goodwill:
- Inspect the selling and purchase agreement and agree the consideration to the selling and purchase agreement;
 - Assess the reasonableness of the business valuation performed by X Limited by reviewing the valuation methodology, data and assumptions used;
 - Assess the competence, objectivity and independence of X Limited to ensure X Limited has the expertise on advising the business valuation and intangible assets;
 - Recalculate the purchase price allocation among assets acquired and liabilities assumed, intangible assets identified and goodwill allocated;
 - Check purchased goodwill is calculated correctly. It should reflect the difference between the fair value of the consideration given and the aggregate of the fair values of the separable net assets acquired; and
 - Review the goodwill impairment assessment performed by CC Limited. Discuss with management the reasonableness of assumptions and data used and appropriateness of the assessment model.

CC Limited's auditor should consider the below audit procedures on purchased intangible assets:

- Inspect the selling and purchase agreement and agree purchased intangibles as to the selling and purchase agreement;
- Inspect the valuation report prepared by X Limited to ensure the valuations of the intangibles are reasonable;
- Assess the reasonableness of the useful lives of the intangible assets estimated by X Limited and management; and
- Recalculate the amortisation calculations of the intangibles prepared by management.

Answer 3

In order to rely on the system as a basis for the figure in the financial statements, the auditor would need to ensure that management had an accurate and up-to date system for ensuring that each item of inventory was counted at least once a year.

Auditors would therefore visit the warehouses during the year, possibly on a rotational basis, to ensure that the system was being operated in a normal manner.

Auditors would ask management about the procedures for inventory counting and review the related documentation, including inventory counting instructions, and form a view as to whether the system was adequate.

Auditors would test check records of goods received and goods despatched and trace them through the inventory system to ensure that records were accurate and input on a timely basis.

Analytical procedures would be performed to establish which warehouses to visit for testing. Warehouses likely to be visited include warehouses where large volumes of inventories were held, warehouses that were experiencing problems or had experienced problems in the past, or warehouses that were considered high risk for other reasons.

Auditors would perform own test checks of inventory and compare with Gourmet's test count results. Using CAATs (computer-assisted audit techniques), including test data and audit software may be necessary.

All exception reports produced by the system should be reviewed to see if there were any recurring or old items and to ensure that all errors and exceptions were being dealt with on a timely basis.

Answer 4

- (a) The auditor uses assertions in assessing risks and designing and performing audit procedures in response to the assessed risks. HKSA 315 (Revised) categorises assertions into those relating to classes of transactions, account balances, and disclosures.

While external confirmations may provide audit evidence regarding these assertions, the ability of an external confirmation to provide audit evidence relevant to a particular assertion varies.

External confirmation of trade receivable provides reliable and relevant audit evidence regarding the existence of the account and customer as at a certain date, eg, 31 March 20X0 for DEF.

However, external confirmation of trade receivable does not ordinarily provide all the necessary audit evidence relating to the valuation assertion because it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the account.

External confirmation of trade receivable also does not ordinarily provide all the necessary audit evidence relating to unrecorded trade receivable balances (the completeness assertion).

- (b) Wong should perform the following additional audit procedures:

- (i) Wong should ask DEF to follow up Debtor A's response by providing the outstanding statement with all necessary details to Debtor A after checking. It is unlikely that this additional audit procedure is impractical.
- (ii) Wong should verify the source and contents of the response in a telephone call to the purported sender of Debtor B, and document oral confirmations in the audit documentation file. Where practicable, Wong should return this response to Debtor B for signature after asking DEF to communicate the issue with Debtor B.
- (iii) Wong should check with DEF if the balance was actually received. Wong should verify it with the bank statement. Wong has to obtain DEF's explanation on the reply of Debtor C's confirmation.

If the HK\$580,000 was received and credited to the wrong customer account, Wong should investigate whether this is a clerical error. To assure both accounts have been properly stated, the account originally credited should be reconfirmed unless the customer has already questioned the propriety of the credit.

If there is no receipt evidence in DEF, Wong has to ask DEF to obtain the payment evidence and sort out the issue with Debtor C. Wong needs to verify evidence once the issue is sorted out. Wong should be alert if there is an unreasonable time lag between the cheque receipt date and the bank-in date, it may be a teeming and lading fraud and Wong should re-assess the audit risk and take necessary action.

- (iv) Debtor D has effectively confirmed a balance of HK\$400,000. The remaining HK\$300,000 goods in transit should be analysed to determine whether there is any cut-off error. Wong should check when the goods were sent to and received by Debtor

D. The remaining HK\$300,000 should be recognised as trade receivable if the arrival date to the seller's port/airport (for FOB shipping point) is on or before 31 March 20X0 and the arrival date to the buyer's port/airport (for FOB destination) is on or before 31 March 20X0.

Answer 5

- (a) Given that the impairment loss for warranty account balance is material, audit steps in accordance with HKSA 540 (Clarified) *Audit of Accounting Estimates* should be undertaken to obtain sufficient appropriate audit evidence to conclude whether the accounting estimates for warranty impairment loss made by the management is reasonable in the circumstances and whether the impairment loss is appropriately disclosed.

In this case, it is appropriate for the auditor to review and test the process used by management to develop the estimate. Given that impairment losses for warranty claims usually take time to realise, it is unlikely that review of subsequent transactions may provide the auditor with further audit evidence regarding an accounting estimate made by management. (However, this does not mean that the auditors need not perform normal procedures on subsequent events, for example, inquire of management whether the claim levels have changed unexpectedly after the year-end.) It is also unlikely that an independent estimate for comparison with that prepared by management is necessary.

In reviewing and testing the process used by management, the auditor would ordinarily perform the following steps:

- (i) Ensure the impairment loss satisfies the recognition criteria under the relevant HKASs
 - (ii) Evaluate the data and consider the assumptions on which the impairment loss warranty is based
 - (iii) Review and/or reperform the calculations involved in the estimate
 - (iv) Compare last year's estimates with the actual warranty costs incurred to determine whether last year's estimate was accurate
 - (v) Consider management's approval procedures and obtain management representations
- (b) HKSA 501 (Clarified) states that when the auditor believes a risk of material misstatement regarding litigation or claims may exist, the auditor should seek direct communication with the entity's legal counsel. Normally, the communication would be in the form of a letter to the external legal counsel that specifies:
- (i) a list of litigation and claims
 - (ii) management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved
 - (iii) a request for the solicitors to confirm the reasonableness of management's assessment of the outcome of the claim and its estimate of the financial implications, including costs involved

The letter, which should be prepared by management and sent by the auditor, should request the entity's legal counsel to communicate directly with the auditor.

Where necessary, the auditor would meet with the entity's legal counsel to discuss the likely outcome of litigation and claims.

- (c) (i) Where time allows, send to the customers details of the outstanding invoices for confirmation. Where this is not practicable, perform appropriate alternative procedures. For example, trace balance to any subsequent cash receipt and agree unpaid amounts to invoices and proof of delivery.

Business Assurance

- (ii) The debtor has effectively confirmed a balance of HK\$170,000. The auditor should trace the remaining HK\$20,000 to subsequent payment or, invoices and proof of delivery.

The exception may indicate a misstatement in the entity's records. In such a case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor reconsiders the nature, timing and extent of audit procedures necessary to provide the audit evidence required.

- (iii) Verify the source and contents of a response in a telephone call to the purported sender, and document oral confirmations in the working papers. Where practicable this response should be returned to the debtor for signing.

- (iv) The balance of HK\$310,000 should be reconciled to the entity's record of HK\$200,000 by verifying any differences in recording payments, invoices and delivery of goods.

The exception may indicate a misstatement in the entity's records. In such a case, the auditor determines the reasons for the misstatement and assesses whether it has a material effect on the financial statements. If an exception indicates a misstatement, the auditor reconsiders the nature, timing and extent of audit procedures necessary to provide the audit evidence required.

Exam practice

**X Limited****21 minutes**

C Limited is a customer of X Limited. In X Limited's accounting records, HK\$2,589,000 is shown as an outstanding balance receivable from C Limited as at 30 June 20Y0. C Limited and X Limited have recently been disputing over the quality of some products delivered from X Limited to C Limited.

Required

You are the auditor of X Limited. Explain how you would evaluate the valuation and allocation assertion of the overall trade receivables balance, in which HK\$2,589,000 due from C Limited is under dispute, in X Limited's accounting records.

(12 marks)**HKICPA June 2011****Z Construction****27 minutes**

A CPA (Practising), Benny, and his team are carrying out the audit of the financial statements for a mid-size construction company called Z Construction. Today, Benny receives the bank reconciliation at the financial year-end date from Z Construction's Financial Controller and the bank confirmation reply from Z Construction's banker. Benny has also asked the financial controller to arrange to send a confirmation letter to Z Construction's lawyer.

Required

- (a) List out the audit procedures that Benny and his team should conduct in respect of the bank reconciliation.
- (7 marks)**
- (b) In addition to the balances of current and deposit accounts, explain two more particular items for the construction industry that Benny and his team should seek to ascertain or confirm from the bank confirmation reply.
- (4 marks)**
- (c) Explain what Benny and his team should seek to ascertain or confirm from the lawyer's confirmation letter.

(4 marks)**(Total = 15 marks)****HKICPA June 2012****Inventory****27 minutes**

You are working on an audit engagement for a client who owns over 150 chain shoe stores in Hong Kong. Your client owns five different shoe brands and each of the brands specialises in a different style of shoe product. During the course of the audit, you look into the inventory ledger and find that the inventory balance as at year end increased three-fold to HK\$200 million compared to last year, representing 20% of the total assets of the company as at year end, and the inventory aging has been deteriorating significantly compared to last year.

You therefore discuss with the management their assessment on the appropriateness of the inventory provision. The managing director explains to you that he is very optimistic about their future development. According to the managing director, they have just acquired three more shoe brands and will open another 50 shoe stores in Hong Kong in the coming year and therefore the inventory balance as at year end had tripled compared to last year. In addition, he is confident that there will be no inventory provision required against their shoe products given that their shoe products are always well-received by their customers in the market.

Required

- (a) Assess and explain the risk of material misstatement relating to the accounting estimate over the inventory valuation as at year end.

(5 marks)

- (b) After talking to the managing director, you are not satisfied with the explanation from the managing director on the inventory. What audit procedures would you further perform in response to the risk of material misstatement discussed in (a)?

(10 marks)

(Total = 15 marks)

HKICPA December 2012

Cash and bank

18 minutes

In a recent dialogue with the internal audit, you understand that the internal audit has issued an unsatisfactory report on the bank reconciliation process of your client. The internal audit report indicated that there was significant control deficiency over the cash management process, and that the management processes and controls were not properly exercised by the operation team.

Required

- (a) Assess and explain the risk of material misstatement relating to the existence and accuracy assertions of the cash and bank balance as at year end.

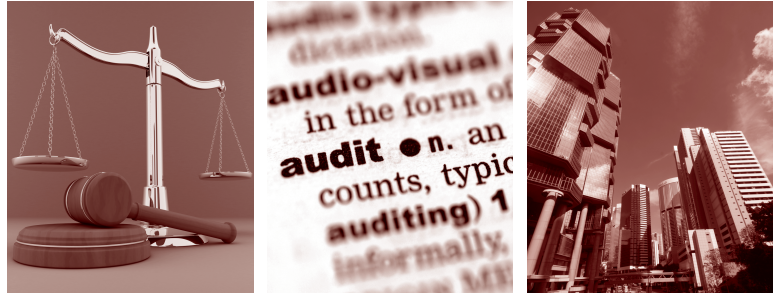
(3 marks)

- (b) Suggest and explain the audit procedures you would perform in response to the risk of material misstatement identified in Question (a).

(7 marks)

(Total = 10 marks)

HKICPA December 2012 (amended)



chapter 14

Using the work of others

Topic list

1 Experts

- 1.1 Using the work of an auditor's expert
- 1.2 Determining the need to use the work of an auditor's expert
- 1.3 Effect of management's expert on the use of auditor's expert
- 1.4 Audit procedures on the work of an auditor's expert
- 1.5 Evaluating the adequacy of the auditor's expert's work
- 1.6 Management's expert

2 Service organisations

- 2.1 Considerations of the entity auditor
- 2.2 Obtaining audit evidence
- 2.3 Service organisation auditor's reports
- 2.4 Reporting

Learning focus

When using the work of third parties, the auditor should consider the scope, the function and the reports involved. You should link the study of this chapter with your knowledge from the previous chapters and should consider the involvement with third parties' work.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.10	Audit evidence	3
2.10.05	Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations	2
2.11	Internal audit	2
2.11.02	Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations	

1 Experts



Topic highlights

External auditors may make use of the work of both the auditor's **expert** or management's expert when carrying out audit procedures to obtain sufficient appropriate audit evidence.

1.1 Using the work of an auditor's expert



Key terms

HKSA 620.6

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. They may be either an auditor's **internal** expert or an auditor's **external** expert.

Management'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 entity to assist the entity in preparing the financial statements.

HKSA
620.7, A4

In accordance with HKSA 620 (Clarified) *Using the Work of an Auditor's Expert* an auditor's expert may be needed to assist the auditor in one or more of the following:

- Obtaining an understanding of the entity and its environment, including its internal control
- Identifying and assessing the risks of material misstatement
- Determining and implementing overall responses to assessed risks at the financial statement level
- Designing and performing further audit procedures to respond to assessed risks at the assertion level, comprising tests of controls or substantive procedures
- Evaluating the sufficiency and appropriateness of audit evidence obtained in forming an opinion on the financial statements

The following list gives examples of the audit evidence which might be obtained from the use of an auditor's expert:

- (a) **Valuing certain types of assets**, e.g. land and buildings, plant and machinery, complex financial instruments and so on
- (b) **Performing the actuarial calculation of liabilities** associated with insurance contracts or employee benefit plans
- (c) **Estimating** oil and gas reserves
- (d) **Valuing environmental liabilities** and site clean-up costs
- (e) **Interpreting** contracts, laws and regulations
- (f) **Measuring work completed** and **work-in-progress** on contracts-in-progress
- (g) **Analysing** complex or unusual tax compliance issues

The **objectives** of the auditors are to determine whether:

- to **use** the work of an auditor's expert
- that work is **adequate** for the auditor's purposes if using the work of an auditor's expert

HKSA 620 (Clarified) does not deal with:

- situations where the engagement includes a member with expertise in a specialised area of accounting and auditing, which is dealt with in HKSA 220 (Clarified) *Quality Control for an Audit of Financial statements*; or
- the auditor's use of the work of an individual or organisation possessing expertise in a field other than accounting and auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements, which is dealt with in HKSA 500 (Clarified) *Audit Evidence*.

1.2 Determining the need to use the work of an auditor's expert

HKSA 620.A8

HKSA 620 (Clarified) requires that the auditor shall determine whether to use the work of an auditor's expert due to the auditor's lack of expertise. Further, the auditor should consider **when and to what extent** to use the work of an auditor's expert and ascertain the nature, extent and timing of audit procedures.

The engagement partner is required to be satisfied that the engagement team and any auditor's experts, collectively have the **appropriate competence and capabilities** to perform the audit engagement.

When considering whether to use the work of an auditor's expert, the auditors should review:

- whether management has used a management's expert in preparing the financial statements
- the **materiality** of the financial statement item being considered
- the **risks of material misstatement** based on the nature and complexity of the matter
- the **quantity** and **quality** of other available **relevant audit evidence**
- the **expected nature of procedures** to respond to identified risks

1.3 Effect of management's expert on the use of auditor's expert

HKSA 620.A9

When management has used a management's expert in preparing the financial statements, the auditor's consideration of using an auditor's expert should be based on the following factors:

- the nature, scope and objectives of the management's expert's work
- whether management's expert is an employee of the entity or is specially engaged to provide specific engagements
- the extent that management can exert influence or control over the work of management's expert
- the competence and capabilities of the management's expert
- the technical regulations or standards with which the management's expert has to comply
- controls within the entity over the management expert's work

Further issues related to management's expert are described in Section 1.6 in this chapter.

The auditor can still obtain a sufficient understanding of the entity's area of business, even without the use of an auditor's expert. Ways of obtaining the understanding can be to:

- consider experience of other clients that require such expertise
- consider the auditor's education or professional development in the particular area of inquiry
- discuss with auditors who have performed similar engagements

1.4 Audit procedures on the work of an auditor's expert

HKSA 620.8-9, 11

HKSA 620 (Clarified) requires that the auditor shall consider the following when determining the nature, extent and timing of the procedures of the work of an auditor's expert.

Such factors are:

- the nature of the matter to which that expert's work relates
- the risks of material misstatement in the matter that involves the expert's work
- the significance and impact of that expert's work in the audit
- the auditor's knowledge of and experience with previous work of auditor's expert
- whether the expert is subject to the audit firm's quality control policies and procedures

1.4.1 Competence, capabilities and objectivity of the auditor's expert

HKSA 620 (Clarified) requires that the auditors shall evaluate the **competence, capabilities and objectivity** of the auditor's expert to consider whether the work of the auditor's expert is adequate for the auditor's purposes. The auditor can discuss with auditors who have performed similar engagements or discuss with the expert.

Competence of the auditor's expert

Competence relates to the nature and level of expertise of the auditor's expert. Auditors should consider the following:

- The expert's **professional certification**, or licensing by, or membership of, an appropriate professional body
- The expert's **experience and reputation** in the field in which the auditors are seeking audit evidence

Field of expertise

HKSA 620 (Clarified) requires that the auditor shall obtain understanding of the **field of expertise** of the auditor's expert by considering:

- whether the expert's field has heavy impact on the audit;
- whether any professional or other standards, and regulatory or legal requirements apply;
- what assumptions and methods are used by the auditor's expert; and
- the nature of internal or external data that the auditor's expert uses.

Capabilities of the auditor's expert

Capabilities relate to the ability of the auditor's expert to exercise his competence in the engagement, for example, factors such as geographical location, and the availability of time and resources.

Objectivity of the auditor's expert

Objectivity relates to the possible influences on the judgment of the auditor's expert causing him to be biased, perhaps through a conflict of interest. The auditor shall consider circumstances causing threats to independence and the possible safeguards to reduce the threats.

HKSA 620 (Clarified) requires that the auditor shall specifically inquire as to interests and relationships that may create a threat to that **expert's objectivity**. Specific inquiries should be performed on:

- any known interests or relationships that the entity has with the auditor's external expert that may affect the objectivity of the auditor's expert ie **financial interest in the entity, business and personal relationships** and the **provision of other services**
- the applicable safeguards that are required to reduce threats to an acceptable level

If the auditors have **reservations** about the competence or objectivity of the expert they may need to carry out other procedures or obtain evidence from another expert.

Other matters that the auditor should consider include:

- the relevance of the auditor's expert's competence to be applied in other areas in the audit
- the auditor's expert's competence with respect to relevant accounting and auditing requirements

- (c) any unexpected events, changes in considerations, or the audit evidence obtained from the results of audit procedures

1.4.2 Agreeing in writing with the auditor's expert

HKSA 620 (Clarified) requires that the auditor shall agree, **in writing** on the following matters:

- (a) the nature, scope and objectives of the auditor's expert's work
 (b) the respective roles and responsibilities of the auditor and the auditor's expert
 (c) the nature, extent and timing of communications, including types of report between auditor and the auditor's expert
 (d) confidentiality requirement imposed on the auditor's expert

1.5 Evaluating the adequacy of the auditor's expert's work

HKSA
620.12, 14, 15

HKSA 620 (Clarified) requires that the auditor shall evaluate the adequacy of the auditor's expert's work based on the following:

Factors	Details
The relevance and reasonableness of auditor's expert's findings or conclusions	<p>Auditor can use specific procedures such as:</p> <ul style="list-style-type: none"> • inquire of auditor's expert • review working papers and reports of auditor's expert • discuss with another expert with that relevant expertise • discuss with management the report of the auditor's expert • other procedures such as observation of expert's work or confirming with third parties <p>The factors that the auditor should consider for evaluation are whether:</p> <ul style="list-style-type: none"> • the conclusions are presented consistently and clearly in accordance with standards of the auditor's expert's profession • the conclusions are based on an appropriate period and have taken into account any subsequent event • the conclusions are subject to any limitations and restrictions • the conclusions are based on appropriate considerations of errors or deviations
The relevance and reasonableness of significant assumptions and methods used by the auditor's expert	<p>The auditor shall consider whether the auditor's expert has adequately reviewed the assumptions and methods and in addition consider any models used, whether they are accepted in the auditor's expert's field.</p> <p>The assumptions should be generally accepted within the auditor's expert's field and should conform with the requirements of the applicable financial reporting framework.</p>
The relevance, completeness and accuracy of the source data used by the auditor's expert	<p>The auditor shall verify the origin of the data and review the data for completeness and internal consistency.</p>

1.5.1 Inadequacy in the work of the auditor's expert

When the auditor determines that the work of the auditor's expert is not adequate enough to satisfy the auditor's purpose, the auditor shall:

- (a) agree with the auditor's expert the nature and extent of further work to be performed by the auditor's expert
- (b) perform additional appropriate audit procedures

1.5.2 Audit reporting

When the auditor concludes that:

- the work of the auditor's expert is not adequate,
- additional audit procedures cannot resolve the issue, and
- the conclusion is that no sufficient and appropriate audit evidence could be obtained,

under HKSA 705 (Clarified), the auditor shall **modify** the audit opinion. Any reference to the auditor's expert's work, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for their opinion.

The auditor shall **not refer** to the work of an auditor's expert in an auditor's report when an unmodified opinion is expressed unless required by law or regulations. If such a reference is required the auditor must indicate that this reference does not reduce the auditor's responsibility for the auditor's opinion.

If the auditor makes reference to the work of an auditor's expert in the auditor's report because such a reference is relevant to the understanding of a modification, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion. In such circumstances, the auditor may need the consent from the auditor's expert before making such a reference.

1.6 Management's expert

HKSA 500.8

The entity may engage a management's expert who possesses expertise in a field other than accounting or auditing in preparing the entity's financial statements. HKSA 500 (Clarified) *Audit Evidence* applies when information prepared by the work of management's expert, is to be used as evidence. In such cases, the auditor shall:

- evaluate the competence, capabilities and objectivity of that management's expert
- obtain an understanding of the work of that management's expert
- evaluate the appropriateness of that management's expert's work as audit evidence related to the assertion

This is similar to Section 1.4 of this chapter when describing the work of an auditor's expert.

1.6.1 Threat to independence of management's expert

As the management's expert may be an employee of the entity, a threat to objectivity always exists. Threats to independence may involve the basic five threats described in the *Code of Ethics* described in detail in Chapter 4; that is the threats of self-interest, self-review, familiarity, advocacy and intimidation.

Safeguards relating to the management's expert's profession, legislation or regulation or by the work environment of the management's expert may be used to reduce the threats. More relevant than safeguards may be discussion with management and the expert regarding any interests and relationships that may give rise to such threats.



Self-test question 1

You are an audit manager of ABC & Co and you are engaged in the audit of EX3's financial statements for the year ended 31 December 20X0. On 1 July 20X0, EX3 acquired a 70 per cent equity interest in Subsidiary Three Limited ("Sub-3") for a cash consideration of HK\$400,000,000. A firm of professional surveyors, Very Professional Surveying Limited ("VPS"), was appointed by EX3 to value the buildings of Sub-3. The fair values of the buildings of Sub-3 were, in total, HK\$50,000,000 above their carrying amounts at 1 July 20X0 after taking into account depreciation up to 30 June 20X0. These valuation surpluses had not been adjusted in the books of Sub-3. According to the relevant accounting standard, the buildings should be initially carried in EX3's consolidated financial statements at fair value at the date of acquisition. The buildings have a useful life of 50 years.

Required

- (a) Explain why your firm may decide to rely on the work of VPS.
- (b) Determine how your team would satisfy yourselves that VPS is a suitable candidate to rely on.

(The answer is at the end of the chapter)



Self-test question 2

Metropolitan Group is a company listed on the Hong Kong Stock Exchange. It is one of the large retailing companies in the Asia-Pacific region with around 130 locations. In 20X9, Metropolitan generated sales of HK\$3,888 million and inventories of HK\$420 million. Its sales brands "Metro Boy" and "Junior Star" command leading market positions in their respective segments.

Simon, senior audit manager of Law & Co. (Law), is responsible for the financial statement audit of the Metropolitan Group for the year ended 30 June 20X0. In accordance with the valuation report prepared by XYZ Valuation and Professional Services Limited (XYZ), a firm of business valuers engaged by Law, the fair value of the brand name of "Junior Star" at 30 April 20Y0 was HK\$100 million. Metropolitan Group would like to disclose this information in the notes to the financial statements. The brand name is carried at cost of registration of HK\$200,000.

Required

Assuming Law is going to rely on the valuation report prepared by XYZ, describe the audit procedures to accept XYZ's work as audit evidence and as consideration to express the auditors' opinion on disclosure requirement.

(10 marks)

HKICPA December 2010 (amended)

(The answer is at the end of the chapter)

2 Service organisations



Topic highlights

A **service organisation** provides outsourced services to another entity. This raises particular concerns for the auditor.



Key terms

A **service organisation** is a third party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

A **user entity** is an entity that uses a service organisation and whose financial statements are being audited.

A **type 1 report** is a report on the description and design of a service organisation's controls.

A **type 2 report** is a report on the description and design of a service organisation's controls and their operating effectiveness.

For auditors whose client uses a service organisation to outsource its non-core activities HKSA 402 (Clarified) *Audit Considerations Relating to an Entity using a Service Organisation* provides guidance as to how to audit this relationship. It states that the objectives of the auditor are to:

- (a) obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement; and
- (b) design and perform audit procedures responsive to those risks.

The HKSA identifies a number of directly relevant activities which are often performed in this way (by no means, an exhaustive list):

- maintenance of accounting records
- management of assets
- initiating, recording or processing transactions as agents of the user entity

Who determines the processes and operational controls over the service activity depends on the nature of the contract between the two parties:

- (a) When the services provided by the service organisation are **limited to recording and processing entity transactions** and the entity retains authorisation and maintenance of accountability, the entity may be able to implement effective policies and procedures within its own control environment.
- (b) When the service organisation **executes** the entity's **transactions** and **maintains accountability**, the entity may deem it necessary to rely on policies and procedures at the service organisation.

2.1 Considerations of the entity auditor

The HKSA states that when obtaining an understanding of the user entity the user auditor must obtain an understanding of how a user entity uses the services of a service organisation.

Information on the nature of services provided will be available from a wide variety of sources including:

- user manuals
- system overviews
- technical manuals
- the contract or service level agreement between the user entity and the service organisation
- reports by service organisations, internal auditors or regulatory authorities on controls at the service organisation
- reports by the service auditor, including management letters

In obtaining an understanding of the entity, the auditor will also consider these factors:

HKSA
402.8e, i

HKSA 402.9,
12, A12-13

- (a) the **nature of the services** provided by the service organisation and the significance of those services to the user entity
- (b) the nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation
- (c) the degree of interaction between the activities of the service organisation and those of the user entity
- (d) the nature of the relationship between the user entity and the service organisation, including the relevant contractual terms for the activities undertaken by the service organisation

When obtaining an understanding of internal control the user auditor must evaluate the design and implementation of relevant controls at the user entity that relate to the services provided by the service organisation, including those that are applied to the transactions processed by the service organisation. Where the user entity has established controls over the service organisation's services the auditor may be able to rely on these regardless of the controls in place at the service organisation. The auditor would need to perform tests of controls in this situation and the extent of reliance would depend on the results of these tests.

If the user auditor is unable to obtain a sufficient understanding from the user entity, the user auditor shall obtain audit evidence from one or more of the following procedures:

- (a) obtaining a **Type 1 report** or **Type 2 report** (see Section 2.3 below);
- (b) contacting the service organisation via the user entity in order to obtain specific information;
- (c) requesting that another auditor be engaged to perform procedures that will provide the necessary information; or
- (d) visiting the service organisation and performing such procedures.

2.2 Obtaining audit evidence

HKSA
402.15, 16

HKSA 402 (Clarified) states that:

In responding to assessed risks in accordance with HKSA 330 (Clarified), the user auditor shall:

- (a) determine whether **sufficient appropriate audit evidence** concerning the relevant financial statement assertions is available from records held at the user entity; and if not
- (b) perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Where the auditor has an expectation that controls at the service organisation are operating effectively and the auditor wishes to rely on these audit evidence must be obtained from one or more of the following procedures:

- (a) obtaining a Type 2 report, if available
- (b) performing appropriate tests of controls at the service organisation
- (c) using another auditor to perform tests of controls at the service organisation on behalf of the user auditor

2.3 Service organisation auditor's reports

Service organisation auditors will usually supply one of two types of report:

- (a) **Report on suitability of design.** This is the basic report.
- (b) **Report on suitability of design and operating effectiveness.** This contains a report on design, **plus** an opinion by the service organisation auditor that the accounting and internal control systems are operating effectively based on the results from the tests of controls.

While reports on design may be useful to an entity auditor in gaining the background understanding of the accounting and internal control systems involved, it would not be used as a basis for reducing the assessment of control risk.

A report on operating effectiveness is much more useful since tests of controls have been performed and it may be used as evidence to support a lower control risk assessment. For this to happen an entity auditor would have to consider whether the controls tested by the service organisation auditor are relevant to the entity's transactions (ie whether they relate to significant assertions in the entity's financial statements) and whether the service organisation auditors' tests of controls and the results may be relied on.

The auditor of a service organisation may be engaged to perform **substantive procedures** that are of use to an entity auditor. Such engagements may involve the performance of procedures agreed upon by the entity and its auditor and by the service organisation and its auditor.

2.4 Reporting

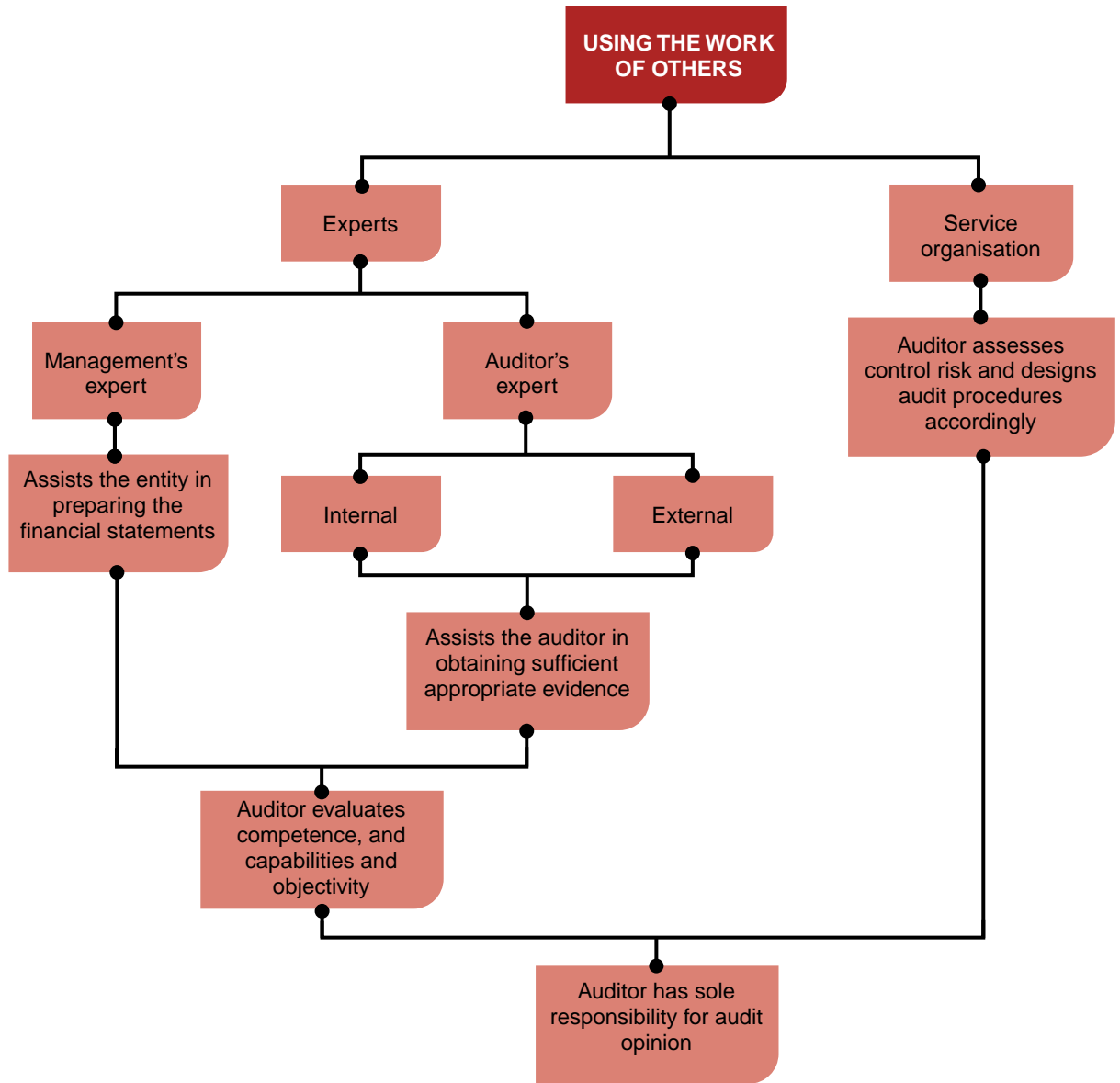
HKSA
402.20-22

The auditor is always **solely responsible** for the audit opinion. He must be assured that he has gained sufficient appropriate audit evidence to form an opinion on the financial statements and he must then express his opinion in the audit report.

It would therefore be **inappropriate** to refer to the work of others in the audit report. His conclusions on the work of others should, however, be adequately documented in the audit file.

If reference to the service organisation is relevant to an understanding of a modified audit opinion the audit report must indicate that this reference does not diminish the auditor's responsibility for that opinion.

Topic recap



Answers to self-test questions

Answer 1

- (a) The auditor's education and experience enable the auditor to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation, such as an actuary or engineer. The valuation of the building of EX3 in this case requires expert's knowledge that ABC & Co does not have. Therefore, ABC & Co needs to rely on the work of VPS.
- (b) In accordance with HKSA 620 (Clarified) *Using the Work of an Auditor's Expert*, when ABC & Co plans to use the work of VPS, ABC & Co should evaluate (1) the professional competence of VPS; and (2) the objectivity of VPS.

ABC & Co assesses VPS's professional competence by considering the following:

- (i) VPS's professional certification or licensing by, or membership in, an appropriate professional body. For example, the legal and professional status of the professional body that licenses VPS to perform property valuation.
- (ii) Experience and reputation in the field in which ABC & Co is seeking audit evidence, that is, experience in the type and location of building that EX3 acquired through Sub-3.

The risk that VPS's objectivity will be impaired increases when VPS is (1) employed by EX3 (which is not likely in this case); or (2) related in some other manner to EX3, for example, by being financially dependent upon or having an investment in EX3.

If ABC & Co is concerned about the competence or objectivity of VPS, ABC & Co needs to discuss any reservations with management and consider whether sufficient appropriate audit evidence can be obtained concerning the work of VPS. ABC & Co may need to undertake additional audit procedures or seek audit evidence from another property valuer when it is necessary.

Answer 2

If Law is going to rely on XYZ's valuation report for the purpose of disclosing the fair value of brand name in the notes to the financial statement, Law should ensure its audit procedures fully comply with HKSA 620 (Clarified) *Using the Work of an Auditor's Expert*.

Law should make an assessment on the competence, capabilities and objectivity of XYZ.

Law should determine the nature, scope and objectives of XYZ's work for Law's purposes and evaluate the adequacy of that work for Law's purposes.

This involves assessing whether the substance of XYZ's findings have been properly reflected in the notes disclosure of the brand name. Particularly, Law should consider whether:

- the source data used by XYZ is appropriate in the circumstances. For example, reviewing or testing the data used by XYZ.
- the assumptions and methods used by XYZ are reasonable and appropriate, and whether they are consistently applied in prior periods.
- the results of XYZ's work are reasonable based on Law's knowledge of Metropolitan Group's business and the results of other audit procedures.

Business Assurance

- the effective date of XYZ's findings (30 April 20Y0) is acceptable when comparing with Law's report date.

If the results of XYZ's work do not provide sufficient appropriate audit evidence, or if the results are not consistent with other audit evidence, Law should resolve the matter.

Law may discuss the issue with Metropolitan Group and XYZ, and apply additional procedures, including possibly engaging another expert or modify the auditor's report.

Law should not refer to the work of XYZ when issuing an unmodified auditor's report for Metropolitan Group's audit because such a reference might be misunderstood to be an audit qualification or a division of responsibility between Law and XYZ.

If Law decides to add an emphasis of matter paragraph to their report or to issue a qualified opinion as a result of XYZ's work, Law may in the auditor's report make a reference to the identification of XYZ as the expert and the extent of XYZ's involvement. Such a reference will facilitate an understanding of the modification. Law should indicate in the auditor's report that such reference does not reduce its responsibility for that opinion.

When Law decides to make a reference to XYZ in the auditor's report, Law would first obtain permission from XYZ. If permission is refused and Law believes that such a reference is necessary, Law may consider obtaining legal advice.

Exam practice



Management's expert

18 minutes

Your firm has recently been engaged in the audit of the financial statements of a new client, which is a Hong Kong residential property developer. In accordance with the company's accounting policy, residential properties under development are carried at the lower of their costs and net realisable values. In order to ascertain the net realisable values of the residential properties under development, the company has employed High Value Surveyors Limited ("HVSL"), a firm of property consultants, to prepare a valuation report on the development projects.

Required

Explain why your firm may decide to rely on the work of HVSL and how your firm would satisfy itself that HVSL is a suitable candidate to rely on.

(Total = 10 marks)



chapter 15

Accounting estimates, opening balances and comparatives

Topic list

1 Accounting estimates

- 1.1 The nature of accounting estimates
- 1.2 Estimation uncertainty
- 1.3 Responsibilities of management
- 1.4 Responsibilities of auditors – risk assessment procedures required
- 1.5 Responsibilities of auditors – responding to the assessed risks
- 1.6 Final evaluation of accounting estimates – reasonable or misstated
- 1.7 Indications of possible management bias

2 Opening balances

- 2.1 Auditor's objectives in respect of opening balances
- 2.2 Audit procedures on opening balances
- 2.3 Specific audit procedures
- 2.4 Material misstatements in opening balances
- 2.5 Effect of a modification to the predecessor auditor's opinion
- 2.6 Audit conclusions and reporting

3 Comparatives

- 3.1 What type of comparatives are they?
- 3.2 Audit procedures on comparative information

Learning focus

When an estimate is involved, the use of judgment means the level of risk is higher. Be alert for assertions that are likely to be estimates or subjective valuations.

When auditing fair values, auditors should consider whether there is an active open market, if not valuation models should be used.

An incoming auditor should perform appropriate audit procedures to verify the opening balances.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.09	Audit procedures	3
2.09.10	Discuss the audit problems and identify procedures for the audit of:	
2.09.10.01	Accounting estimates	
2.09.10.02	Fair values	
2.09.10.03	Opening balances	
2.09.10.04	Comparatives	

1 Accounting estimates



Topic highlights

When auditing **accounting estimates** auditors should:

- test the management process
- use an independent estimate
- review subsequent events

in order to assess whether the estimates are reasonable.

1.1 The nature of accounting estimates

HKSA 540.6

HKSA 540 (Clarified) *Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures* provides guidance on the audit of accounting estimates contained in financial statements. The auditor's objective is to obtain sufficient appropriate audit evidence about whether accounting estimates are reasonable and related disclosures are adequate.



Key term

HKSA 540.7a

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

The responsibility for making estimates lies with management or those charged with governance. Some estimates are routine and some are one-off. Many estimates are capable of reasonable estimation but some complex estimates may involve special knowledge and judgment.

Examples of accounting estimates include the following:

- Estimate of impairment of account receivables
- Inventory obsolescence – estimate of net realisable value of inventories
- Warranty obligations – estimate of the provision
- Depreciation method or asset useful life
- Outcome of long-term contracts
- Costs arising from litigation settlements and judgments – contingent liabilities
- Impairment of the carrying amount of an investment where there is uncertainty regarding its recoverability
- Complex financial instruments, which are not traded in an active and open market
- Share-based payments
- Property or equipment held for disposal
- Deferred tax
- Non-monetary consideration, for example exchange of plant facilities

1.2 Estimation uncertainty



Key term

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

HKSA 540.7c

HKSA
540.11, A38

The degree of estimation uncertainty **varies** based on the:

- (a) nature of the accounting estimate
- (b) extent to which there is a generally accepted method or model used to make the accounting estimate
- (c) subjectivity of the assumptions used to make the accounting estimate

When preparing the financial statements, this may involve estimation which includes judgment based on information available at that time.

Some accounting estimates involve **low estimation uncertainty** but alternatively some may involve **high estimation uncertainty**. The table below gives example of both categories:

Examples of low estimation uncertainty	Examples of high estimation uncertainty
<ul style="list-style-type: none"> • Relate to entities that are not engaged in complex business activities • Accounting estimates are frequently updated due to routine transactions • The method of measurement of the fair value accounting estimates based on applicable financial reporting framework is simple and can be applied easily • The model used to measure the fair value accounting estimates is well-known or generally accepted 	<ul style="list-style-type: none"> • Accounting estimates relating to the outcome of litigation • Fair values accounting estimates for: <ul style="list-style-type: none"> – derivative financial instruments not publicly traded – highly specialised entity-developed model is used for which assumptions or inputs cannot be observed in the marketplace

The auditor shall obtain **understanding** of whether and if so, how management has assessed the effect of estimation uncertainty. For example:

- (a) how management has considered alternative assumptions or outcomes
- (b) how management determines the accounting estimate when analysis indicates a number of outcome scenarios
- (c) whether management monitors the outcome of accounting estimates and has responded appropriately.

1.2.1 Degree of estimation uncertainty associated with an accounting estimate

The auditor shall **evaluate** the degree of estimation uncertainty associated with an accounting estimate and in addition, the auditor shall consider whether the identified accounting estimates involve high estimation uncertainty that gives rise to **significant risk**.

The degree of estimation uncertainty associated with an accounting estimate may be influenced by the following factors:

- (a) whether accounting estimates are heavily dependent on judgment
- (b) whether the accounting estimates are heavily sensitive to changes in assumptions

- (c) whether there are existing recognised measurement techniques to mitigate the estimation uncertainty
- (d) the consideration of the length of the forecast period
- (e) the availability of reliable data from external sources
- (f) the inputs contributed to the accounting estimate

1.3 Responsibilities of management

It is **management's responsibility** to make accounting estimates to be included in the financial statements. The process of making accounting estimates always involves high level of judgment due to the existence of uncertainty regarding the outcome of events.

Formulae used in forming the accounting estimates need to be reviewed regularly by management.

Some financial statement items cannot be measured precisely, only estimated. The **nature and reliability** of information available to management to support accounting estimates can vary enormously and this therefore affects the **degree of uncertainty** associated with accounting estimates, which in turn affects the **risk of material misstatement** of accounting estimates.

Therefore, when accounting estimates are involved, **inherent risk** (and therefore audit risk) **increases** and in return, the risks of material misstatement increases.

1.4 Responsibilities of auditors – risk assessment procedures required

HKSA 540.8

The auditor must obtain **sufficient and appropriate** audit evidence regarding accounting estimates. The auditor should exercise **professional judgment** when performing audit procedures in regard to the accounting estimates.

HKSA 540 (Clarified) requires that the auditor shall obtain an understanding of the following to provide a basis for the **identification and assessment** of the risks of material misstatement for accounting estimates:

(a) **The requirements of the applicable financial reporting framework**

The auditor shall obtain an understanding of the requirements of the applicable financial reporting framework by determining the conditions for the recognition or methods for measuring accounting estimates and the specific disclosures of the accounting estimates.

(b) **How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates**

The auditor shall inquire of management as to how management identifies the need for accounting estimates ie by making inquiries to ascertain management's knowledge of the entity's business, industry, implementation of business strategies and their cumulative experience for preparing the financial statements.

In other situations, the auditor may perform risk assessment procedures directed at the methods and practices used as part of the entity's formal risk management function.

(c) **How the management makes the accounting estimates**

The auditor shall consider the types of accounts to which the accounting estimates relate and whether management has used recognised measurement techniques for making the accounting estimates. The auditor shall perform inquiries to ascertain whether matters relating to subsequent events have been treated appropriately. (Subsequent events are covered in detail in the next chapter.)

(d) **Method of measurement**

The auditor shall consider whether the accounting estimates are made in accordance with HKFRSs or another framework. There would be a higher level of risk if management is using an internally developed model in making the accounting estimate or using a method not commonly used in the industry.

(e) **Relevant controls**

The auditor shall consider the experience and competence of those of make the accounting estimates and controls relating to:

- (i) how management determines the completeness, relevance and accuracy of the data used
- (ii) the review and approval of accounting estimates
- (iii) the segregation of duties of those managing the entity and those responsible for making the accounting estimates

(f) **Assumptions underlying the accounting estimates**

The auditor shall consider the assumptions underlying the accounting estimates by taking into the account of:

- (i) the nature of the assumptions
- (ii) how management assesses whether the assumptions are relevant and complete
- (iii) how management considers the assumptions used are consistent
- (iv) how the assumptions used conform with the entity's business plans and environment

(g) **Changes in methods for making accounting estimates**

The auditor shall determine whether there ought to be a change in the methods for making accounting estimates as compared to last year. If management has changed the assumption, management should demonstrate that that the new method is more appropriate.

(h) **Reviewing prior period accounting estimates**

The auditor may review the prior period accounting estimates as a risk assessment procedure in accordance with the HKSA.

1.5 Responsibilities of auditors – responding to the assessed risks

HKSA
540.12-16

HKSA 540 (Clarified) requires that, based on the assessed risks of material misstatement, the auditor shall determine whether the:

- (a) accounting estimate has been made in accordance with the requirements of the **applicable financial reporting framework** such as conforming with HKFRSs
- (b) method used by management for making the accounting estimates are appropriate and have been **applied consistently**
- (c) whether changes in accounting estimates or in the method for making accounting estimates from the prior period are appropriate in the circumstances.

1.5.1 Selection of procedures to perform

HKSA 540 (Clarified) requires the auditor to perform one or more of the following procedures in responding to the assessed risk of material misstatement:

- (a) Determine whether **events occurring up to the date of the auditor's report** provide sufficient and appropriate audit evidence regarding the accounting estimate.

(b) **Test how management made the accounting estimate** and the data used.

The auditor shall evaluate whether the **method of measurement used** is appropriate and the **assumptions used** by management are reasonable. Some of the tests are described below.

- (i) Test the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions
 - (ii) Consider the source, relevance and reliability of external data or information
 - (iii) Recalculate the accounting estimate
 - (iv) Consider whether the accounting estimate is internally consistent
 - (v) Consider management's review and approval processes
- (c) **Test the operating effectiveness of controls** over how management made the accounting estimate when management's process has been well-designed, implemented and maintained. For example:
- (i) **Controls** exist for the review and approval of the accounting estimates by appropriate levels of management and those charged with governance
 - (ii) The accounting estimate is derived from the routine processing of data by the entity's accounting system
- (d) **Develop a point estimate or a range** (see key term below) to evaluate whether management's point estimate may be an appropriate treatment. This may be appropriate in the following circumstances:
- (i) An accounting estimate is not derived from the entity's routine processing of data
 - (ii) Previous experience suggests that management's current period process is unlikely to be effective
 - (iii) The entity's controls for determining accounting estimates are not well designed and implemented
 - (iv) Subsequent events contradict management's point estimate
 - (v) Alternative sources of relevant data are available to use in making a point estimate or a range

HKSA 540 (Clarified) requires that, when developing a point estimate or a range to evaluate management's point estimate if the auditor **uses different assumptions or methods** compared to management and concludes that it is inappropriate to use a range, then the auditor shall narrow the range.

When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate the auditor shall narrow the range based on audit evidence available, until all outcomes within the range are considered reasonable.

- (e) **Disclosure relating to accounting estimates** – the auditor shall obtain sufficient appropriate the audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.



Key terms

HKSA
540.7b, e

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

A **management's point estimate** is the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

1.5.2 Further substantive procedures in response to significant risks

When auditing accounting estimates that give rise to **significant risks**, auditors' further substantive procedures should focus on evaluation of the following:

- (a) the **appropriateness of the recognition** of the accounting estimates in the financial statements due to the estimation uncertainty ie management's decision to recognise or not recognise the accounting estimate, with the consideration of disclosure of the circumstances and the selected measurement basis for the accounting estimates
- (b) how management has assessed the **effect of estimation uncertainty** on the accounting estimate
- (c) the **adequacy of related disclosures** in the context of applicable financial reporting framework – the auditor may encourage management to disclose in the notes to the financial statements the circumstances relating to the estimation uncertainty

HKSA 540 (Clarified) requires that, for accounting estimates that give rise to significant risks, the auditor shall evaluate the following:

- (a) how management has considered **alternative assumptions** or outcomes for the accounting estimates
- (b) whether the **significant assumptions used** by management are **reasonable**
- (c) management's intention to carry out specific actions on the accounting estimates and its ability to do so
- (d) whether the auditor needs to develop a range to evaluate the reasonableness of the accounting estimate

1.6 Final evaluation of accounting estimates – reasonable or misstated

HKSA 540.18

Under HKSA 450 (Clarified), a misstatement regarding an accounting estimate, whether caused by fraud or error, may arise as a result of factual misstatements, judgmental misstatements or projected misstatements.

The auditors should make a **final assessment of the reasonableness** of the accounting estimates based on the audit evidence in order to conclude whether the accounting estimates are reasonable or are misstated.

If there are any differences in between management's point estimates and the auditors' point estimates supported by audit evidence, the auditors should consider whether the **difference is a misstatement** which indicates that management's point estimate lies outside the auditors' range.

Where management has changed an accounting estimate, or the method in making the estimate as compared to prior period, which cannot be justified, the auditor may conclude based on the audit evidence that the accounting estimate is **misstated** as a result of an **arbitrary change** by management, or may regard it as an **indicator of possible management bias**.

1.7 Indications of possible management bias



Key term

Management bias is a lack of neutrality by management in the preparation and presentation of information.

HKSA 540.7d

HKSA
540.21-22

During the process of making an accounting estimate, there is **inherent subjectivity** involved and the **susceptibility** of an accounting estimate to management bias increases with the level of subjectivity.

Management bias can be described as **unintentional management bias** or the potential for **intentional management bias** and can be difficult to detect at an **account level**. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates when observed over a number of periods.

For continuing audits, **indicators of possible management bias** identified in **preceding periods** may influence the planning and risk identification and assessment activities of the auditor in the **current period**.

1.7.1 Audit procedures requirement on possible management bias



Topic highlights

Indicators of possible management bias do not necessarily conclude that there are misstatements on the accounting estimates as there may be no intention by management to mislead users of financial statements.

HKSA 540 (Clarified) requires that the auditor shall identify whether there are **indicators of possible management bias** when reviewing the judgment and decisions made by management in the making of accounting estimates during the audit.

Examples of indicators of possible management bias:

- (a) changes in accounting estimate or method of making the accounting estimate, involving management's subjective assessment for that change
- (b) use of entity's own assumptions for fair value accounting estimates when they are inconsistent with assumptions that would otherwise be used in the market
- (c) generating a point estimate favourable for achieving management objective based on significant assumptions selected or constructed
- (d) selecting a point estimate that may indicate a pattern of optimism or pessimism

However, if there is an intention to mislead, management bias is fraudulent, meaning fraud has occurred.

1.7.2 Documentation of indicators of possible management bias

HKSA 540 (Clarified) requires that the auditor shall **document any indicators of possible bias identified** during the audit in concluding whether the auditor's risk assessment and the responses to assessed risks remain appropriate and in evaluating whether the financial statements as a whole are free from material misstatement.

1.7.3 Written representations

Under HKSA 580 (Clarified), **written representations** about accounting estimates recognised or disclosed in the financial statements may include representations on matters such as the following:

- The appropriateness of the measurement processes in the context of the applicable financial reporting framework, and the consistency in application of the processes.
- Whether the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.



Self-test question 1

Metropolitan Group is a company listed on the Hong Kong Stock Exchange. It is one of the large retailing companies in the Asia-Pacific region with around 130 locations. In 20X9, Metropolitan generated sales of HK\$3,888 million and inventories of HK\$420 million. Its sales brands “Metro Boy” and “Junior Star” command leading market positions in their respective segments.

Simon, senior audit manager of Law & Co. (Law), is responsible for the financial statement audit of the Metropolitan Group for the year ended 30 June 20Y0. In accordance with the valuation report prepared by XYZ Valuation and Professional Services Limited (XYZ), a firm of business valuers engaged by Law, the fair value of the brand name of “Junior Star” at 30 April 20Y0 was HK\$100 million. Metropolitan Group would like to disclose this information in the notes to the financial statements. The brand name is carried at cost of registration of HK\$200,000.

Required:

What audit procedures, other than those relating to using the work of XYZ, would Law perform, in accordance with relevant Hong Kong auditing standards, on the proposed fair value disclosure of the brand name “Junior Star” in the notes to the financial statements for the year ended 30 June 20Y0?

(6 marks)

HKICPA December 2010 (amended)

(The answer is at the end of the chapter)

2 Opening balances



Topic highlights

HKSA 510 (Clarified) *Initial Audit Engagements – Opening Balances* provides guidance on opening balances:

- when the financial statements for the prior period were **not audited**
- when the financial statements for the prior period were **audited by a predecessor auditor**, meaning the incoming auditor should obtain sufficient and appropriate audit evidence regarding the opening balances.



Key terms

Opening balances are those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Predecessor auditor is an auditor from a different audit firm who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

HKSA
510.4b, c

2.1 Auditor's objectives in respect of opening balances

HKSA 510.3

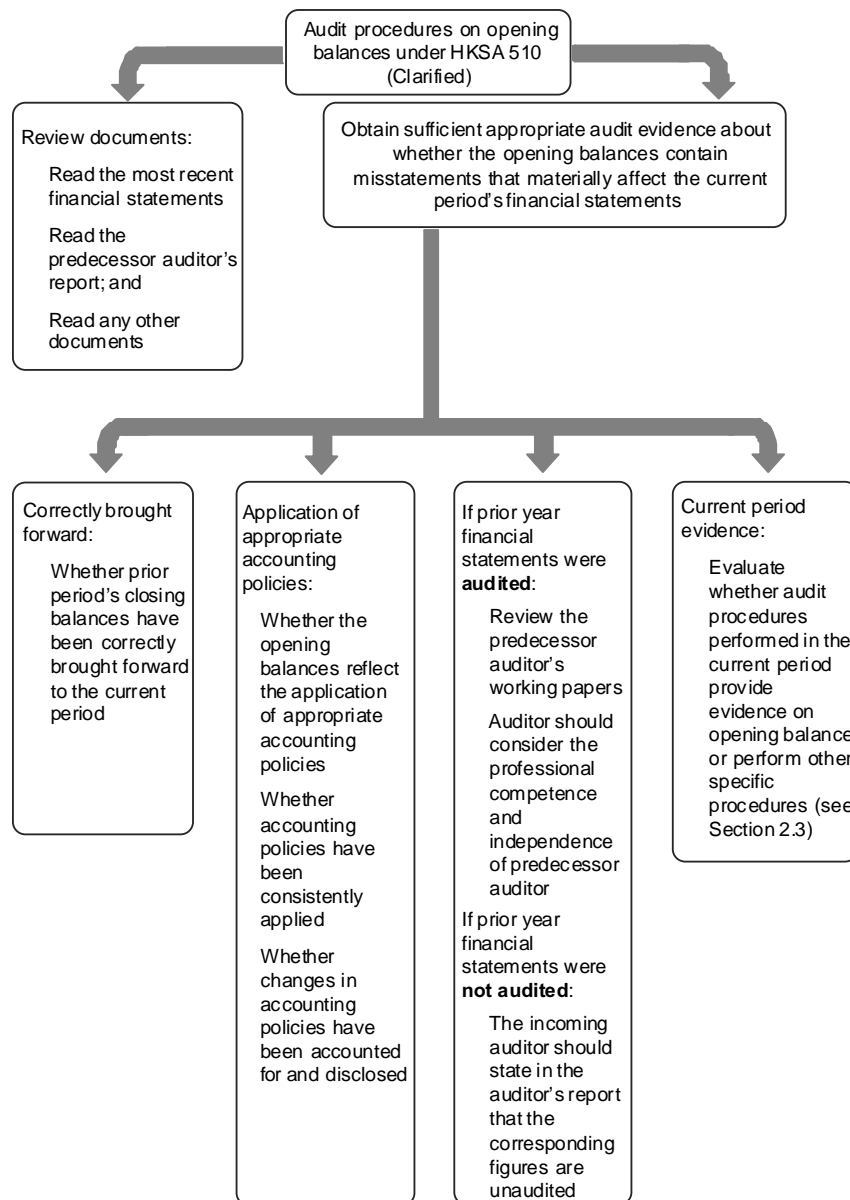
HKSA 510 (Clarified) states that when the auditor conducts an initial audit engagement, the objective with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- opening balances contain **misstatements** that materially affect the current period's financial statements
- appropriate **accounting policies** reflected in the opening balances have been **consistently applied** in the current period's financial statements
- if changes are made, whether these changes are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

2.2 Audit procedures on opening balances

HKSA 510.5,
6, 8

The following flow chart shows the audit procedures on opening balances required by HKSA 510 (Clarified):



2.3 Specific audit procedures

HKSA
510.A6-7

For **current assets and liabilities** some audit evidence may be obtained as part of the current period's audit procedures. For example, the **collection** (payment) of opening accounts **receivable** (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

In the case of **inventories**, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional procedures may be necessary, such as:

- (a) **observing a current physical inventory count** and reconciling it back to the opening inventory quantities
- (b) **performing audit procedures on the valuation** of the opening inventory items
- (c) **performing audit procedures on gross profit** and cut-off

A combination of these procedures may provide sufficient appropriate audit evidence.

For **non-current assets and liabilities**, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

In some situations, the current auditor may wish to hold **consultations with the predecessor auditor**. This is usually limited to seeking information on the predecessor auditor's audit of particular areas (usually high risk areas), or to obtaining clarification of any significant accounting matters that are not adequately dealt with in the client's records.

2.4 Material misstatements in opening balances

HKSA 510.7

If the opening balances contain misstatements that could **affect the current period's financial statements**, the auditor shall perform additional audit procedures to determine the effect on the current period's financial statements. In addition, the auditor shall **communicate** the misstatements with the appropriate level of management and those charged with governance.

2.5 Effect of a modification to the predecessor auditor's opinion

HKSA 510.9

HKSA 510 (Clarified) requires that if the prior period's financial statements were audited by a predecessor auditor and there was a **modification to the opinion**, the auditor shall **evaluate the effect** of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements.

2.6 Audit conclusions and reporting

2.6.1 Limitation on scope

HKSA
510.10-13,
Appendix

If the auditor is **unable to obtain sufficient appropriate audit evidence** regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements, as appropriate.

The following are the illustrative paragraphs in the auditors' reports:



Illustration 1

Circumstances described in the following paragraph include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.

- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's financial performance and cash flows.
- The financial position at year end is fairly presented.

Basis for qualified opinion

We were appointed as auditors of the Company on 30 June 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 31 December 20X0. Since opening inventories enter into the determination of the profit and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the statement of profit or loss and other comprehensive income and the net cash flows from operating activities reported in the statement of cash flows.

Qualified opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the Company's affairs as at 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 disclosure requirements of the Hong Kong Companies Ordinance.



Illustration 2

Circumstances described in the following paragraph include the following:

- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's financial performance and cash flows.
- The financial position at year end is fairly presented.
- An opinion that is qualified regarding the financial performance and cash flows and unmodified regarding financial position is considered appropriate in the circumstances.

Basis for qualified opinion on the profit and cash flows

We were appointed as auditors of the Company on 30 June 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 31 December 20X0. Since opening inventories enter into the determination of the profit and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the statement of profit or loss and other comprehensive income and the net cash flows from operating activities reported in the statement of cash flows.

Qualified opinion on the profit and cash flows

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the statement of profit or loss and other comprehensive income and statement of cash flows give a true and fair view of the Company's profit and cash flows for the year ended 31 December 20X1 in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Opinion on the financial position

In our opinion, the statement of financial position gives a true and fair view of the state of the Company's affairs as at 31 December 20X1 in accordance with Hong Kong Financial Reporting Standards and has been properly prepared in accordance with the Hong Kong Companies Ordinance.

2.6.2 Misstatements in opening balance

If the auditor concludes that the opening balances contain a **misstatement** that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor shall express a **qualified opinion or an adverse opinion**, as appropriate.

2.6.3 Accounting policies not consistently applied

The report will also be modified if **accounting policies** are **not consistently applied**.

If the auditor concludes that:

- (a) the current period's **accounting policies are not consistently applied** in relation to opening balances in accordance with the applicable financial reporting framework
- (b) a **change in accounting policies** is not appropriately properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

the auditor shall express a **qualified opinion or an adverse opinion** as appropriate.

2.6.4 Prior year auditor's report modified

If the prior period auditor's report was modified, the auditor should **consider the effect on the current period's financial statements**. For example, if there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been **resolved** in the current period, the auditor may not need to modify the current period's audit opinion.

If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements.

3 Comparatives

**Topic highlight**

The auditor's responsibilities for comparatives vary depending on whether they are corresponding figures or comparative financial statements.

3.1 What type of comparatives are they?

HKSA
710.5-6

HKSA 710 (Clarified) *Comparative Information – Corresponding Figures and Comparative Financial Statements* establishes standards and provides guidance on the auditors' responsibilities regarding comparatives.

The auditor must determine whether the comparatives comply in all material respects with the financial reporting framework applicable to the financial statements being audited.

Comparative information includes corresponding figures and comparative financial information.



Key terms

HKSA 710.6

Comparative information is the amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

Corresponding figures are amounts and other disclosures for the prior period **included as part of the current period financial statements**, which are intended to be read in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

Comparative financial statements are amounts and other disclosures of the prior period included for comparison with the financial statements of the current period, but, if audited, are referred to in the auditor’s opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

Comparatives are presented in compliance with the relevant financial reporting framework. The essential audit reporting differences are that:

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

3.2 Audit procedures on comparative information

3.2.1 The auditors' responsibilities

HKSA 710.7-19, Appendix

The auditor must determine whether the financial statements include comparative information required by the applicable financial reporting framework and whether such information is appropriately classified.

For this purpose, the auditor shall evaluate whether the

- comparative information agrees with the amounts and other disclosures presented in the prior period, or, when appropriate, have been restated
- accounting policies reflected in the comparative information are consistent with those applied in the current period

For any changes in accounting policy, the auditor shall evaluate whether those changes have been properly accounted for and properly disclosed.

3.2.2 Additional procedures when there is a possible material misstatement

When auditor becomes aware of possible material misstatements in the comparative information during the current period audit, the auditor shall perform **additional audit procedures** to determine whether a material misstatement really exists.

3.2.3 Subsequent events

Under HKSA 560 (Clarified), the standard requires that, if after the financial statements have been issued, a fact becomes known to the auditor that, if it had been known to the auditor at the date of the auditor's report, may cause the auditor to amend the auditor's report, the auditor shall:

- discuss with management and those charged with governance
- determine whether the financial statements shall be amended
- inquire of management as to its intention to address the matter in the financial statements

The auditor shall determine that the comparative information **agrees with the amended financial statements** if the prior period financial statements are amended.

3.2.4 Written representations

For corresponding figures, the written representations are requested for the financial statements of the current period. However, in the case of restatement, HKSA 710 (Clarified) requires the auditor to obtain specific written representations regarding any restatement made to correct a material misstatement in prior period financial statement that affect the comparative information.

3.2.5 Reporting



Topic highlights

The auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.

3.2.6 Modification in auditor's report on the prior period

When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer opinion, or an adverse opinion and the matter which gave rise to the modified opinion is:

Resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework	The auditor's opinion on the current period need not refer the previous modification.
Unresolved	The auditor shall consider whether the modification is relevant to the current period's figures and shall modify the auditor's opinion on the current period's financial statements (see illustrations below).

Illustration examples of the basis for modification are as follows.



Illustration 1

Circumstances described in the following paragraph include the following:

- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are material and require a modification to the auditor's opinion regarding the current period figures.

Basis for qualified opinion

As discussed in Note 10 to the financial statements, no depreciation has been provided in the financial statements, which constitutes a departure from Hong Kong Financial Reporting Standards. This is the result of a decision taken by the directors at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by HK\$1,500,000 in 20X9 and HK\$2,700,00 in 20Y0, property, plant and equipment should be reduced by accumulated depreciation of HK\$1,500,000 in 20X9 and HK\$2,700,000 in 20Y0, and the accumulated loss should be increased by HK\$1,500,000 in 20X9 and HK\$2,700,000 in 20Y0.

Qualified opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20Y0, 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.

**Illustration 2**

Circumstances described in the following paragraph include the following:

- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are immaterial but require a modification to the auditor's opinion because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

Basis for qualified opinion

Because we were appointed auditors of Pluto Limited during 20X9, we were not able to observe the counting of the physical inventories at the beginning of that period or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories affect the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 20X9. Our audit opinion on the financial statements for the period ended 31 December 20X9 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.

Qualified opinion

In our opinion, except for the possible effects on the corresponding figures of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20Y0, and of its [profit][loss] 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.

3.2.7 Misstatement in prior period financial statements

HKSA 710 (Clarified) requires that the auditor shall express **a qualified opinion or an adverse opinion** in the auditor's report on the current period financial statements, modified with respect to the corresponding figures if:

- the auditor has obtained audit evidence that a material misstatement exists in the prior period financial statements
- an unmodified opinion has been previously issued
- the corresponding figures have not been properly restated or appropriate disclosures have been made

3.2.8 Prior period financial statements were unaudited

When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the comparative financial statements are **unaudited**.

Again, the inclusion of such a statement does not relieve the auditors of the requirement to carry out appropriate procedures regarding opening balances of the current period. Clear disclosure in the financial statements that the comparative financial statements are unaudited is encouraged.

In situations where the incoming auditor identifies that the prior year unaudited figures are materially misstated, the auditor should request management to revise the prior year's figures or if management refuses to do so, appropriately modify the report.

3.2.9 Incoming auditors: additional requirements

When the financial statements of the prior period were **audited by another auditor**:

- (a) the predecessor auditor may reissue the audit report on the prior period with the incoming auditor only reporting on the current period
- (b) the incoming auditor's report should state that the prior period was audited by another auditor and the incoming auditor's report should indicate:
 - (i) that the financial statements of the prior period were audited by another auditor
 - (ii) the type of opinion issued by the predecessor auditor and if the opinion was modified, the reasons why
 - (iii) the date of that report



Self-test question 2

You are the audit manager of a CPA firm. You are responsible for the audits of the financial statements of two new clients, XYZ and KLM, for the year ended 31 December 20X3.

Since the auditors' report of XYZ's financial statements for the year ended 31 December 20X2 has not been modified, your assistant has suggested to you that no specific procedures are needed in respect of the opening balances and comparatives relevant to XYZ's financial statements for the current year.

Required

Do you concur with your audit assistant's view about the opening balances and comparatives?

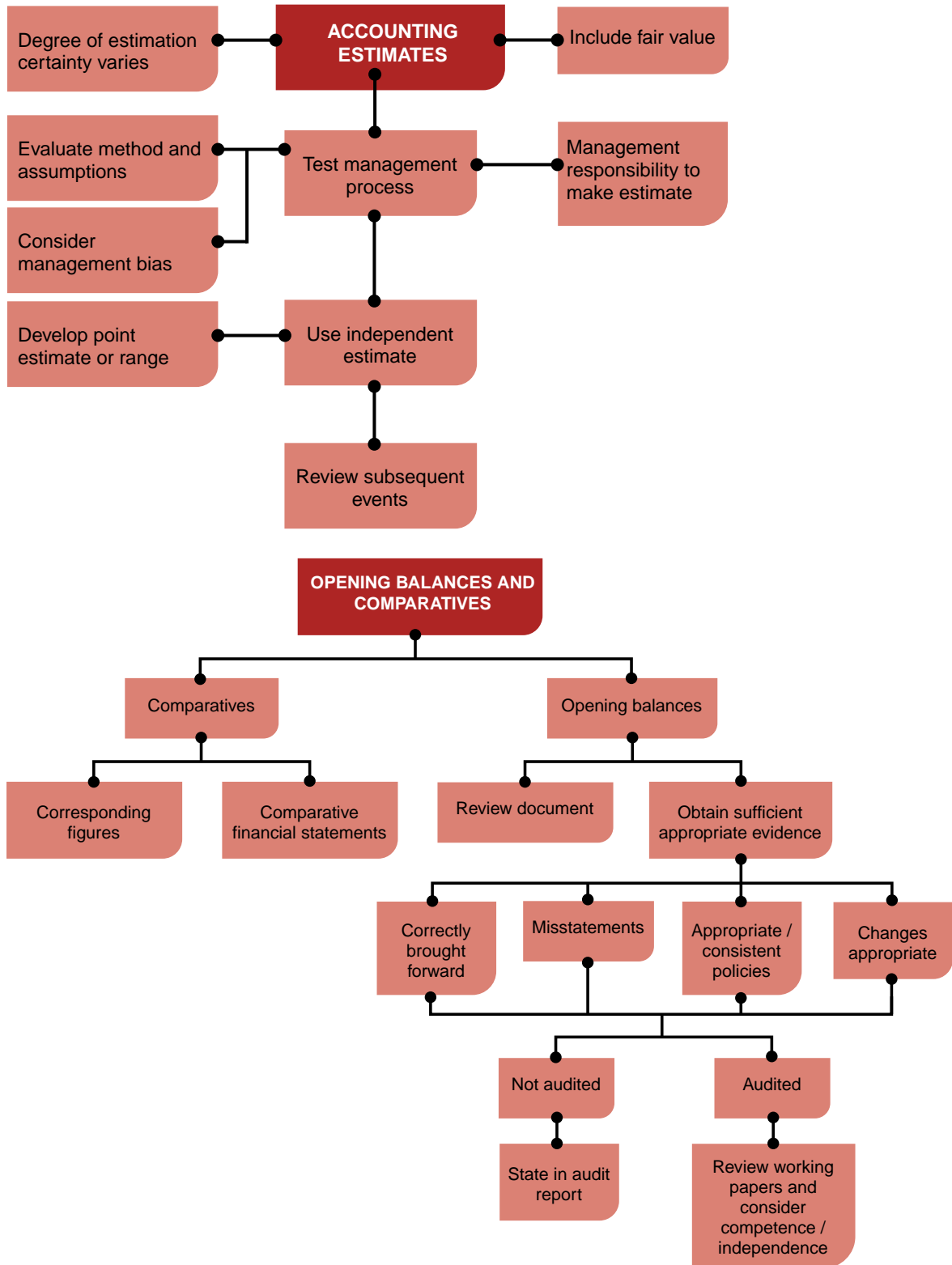
Explain your views.

(6 marks)

HKICPA February 2004

(The answer is at the end of the chapter)

Topic recap



Answers to self-test questions

Answer 1

HKSA 540 (Clarified) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements.

Law should obtain sufficient appropriate audit evidence that fair value measurements and disclosures of the HK\$100 million brand name of “Junior Star” are in accordance with the Hong Kong Financial Reporting Standards (“HKFRS”).

To this end, Law should obtain an understanding of:

- Metropolitan Group’s process for determining fair value measurements and disclosures; and
- the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level and to design and perform further audit procedures.

Law should evaluate whether the fair value measurements and disclosures in the financial statements comply with HKFRS.

Law should test the fair value measurements and disclosure, including the assumptions, valuation method and the data used. Reference to and review of past history of similar intangible assets or accounting treatment should be made.

Law should obtain written representations from Metropolitan Group’s management whether they believe significant assumptions used by the company in making the fair value measurements and disclosures are reasonable.

Law should evaluate the results of the audit procedures performed and conclude whether the fair value measurements and disclosures of the HK\$100 million brand name “Junior Star” are reasonable.

Answer 2

Responsibilities regarding opening balances and comparatives

HKSA 510 (Clarified) requires auditors to obtain sufficient appropriate evidence that:

- (a) opening balances do not contain misstatements which materially affect the current period's financial statements;
- (b) the preceding period's closing balances have been correctly brought forward as opening balances, or when appropriate, have been restated;
- (c) appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed;
- (d) the accounting policies used for the comparatives are consistent with those of the current period or appropriate adjustments and disclosures have been made where this is not the case; and
- (e) the comparatives agree with the amounts and other disclosures presented in the preceding period's financial statements or appropriate adjustments and/or disclosure have been made where this is not the case.

Procedures in general cases

Even if we audited XYZ's financial statements for the year ended 31 December 20X2 and issued an unqualified opinion, we would still need procedures to ensure that opening balances have been appropriately brought forward and that current accounting policies have been consistently applied.

These would normally include a review of the accounting policies adopted in the previous year and an examination of opening balances and comparatives against the previous year's audited financial statements.

Additional procedures as incoming auditors

However, since we have not audited XYZ's previous financial statements, we may need to perform some or all of the following additional procedures to ensure that requirements of HKSA 510 (Clarified) are complied with:

- (a) Hold consultations with management of XYZ;
- (b) Review records, working papers and accounting and control procedures for the preceding period;
- (c) Perform substantive tests on opening balances and comparatives in respect of which the results of other procedures are considered unsatisfactory; and
- (d) Hold consultations with the auditors, if any, who were previously the auditors of the entity.

Exam practice



Ling Limited

25 minutes

Ling Limited reports a net profit of some HK\$48 million in its financial statements for the year ended 30 June 20X0. Extracted below is the independent auditor's report on Ling Limited's financial statements.

**Independent Auditor's Report to the shareholders of Ling Limited
(incorporated in Hong Kong with limited liability)**

We have audited the financial statements of Ling Limited ("the Company") for the year ended 30 June 20X0

Directors' Responsibility for the Financial Statements

.....

Auditor's Responsibility

.....

Basis for Qualified Opinion

We did not observe the counting of physical inventories of one of the Company's warehouses at the end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 30 June 20X0 which are stated in the statement of financial position at a total amount of HK\$1,300,000 at 30 June 20X0. In addition, the introduction of a new computer system on one of the accounts receivable sub-ledgers in April 20X0 resulted in some errors in accounts receivable. As of the date of our audit report, the directors were still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means the accounts receivable sub-ledger which is affected by the new system included in the statement of financial position at a total amount of HK\$1,147,000 as at 30 June 20X0.

As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of inventories and accounts receivable reported in the financial statements.

Qualified Opinion

In our opinion, except for the possible effects of the matters described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the Company's affairs as at 30 June 20X0, 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.

Report on matters under sections 141(4) and 141(6) of the Hong Kong Companies Ordinance

.....

Haddock CPA

Certified Public Accountants (Practising)

Hong Kong

14 September 20X0

Cod CPA has recently been appointed as the auditor of Ling Limited's financial statements for the year ended 30 June 20X1. The client and engagement acceptance procedures have been satisfactorily completed. Cod CPA has also reviewed the situation in respect of the system deficiency of the accounts receivable sub-ledger and has considered that the system now appears to function correctly.

Required

In view of each case above:

- (a) What is Cod CPA's audit objective in respect of Ling Limited's balances of inventories and accounts receivable as at 1 July 20X0?

(5 marks)

- (b) In view of the qualified auditor's report issued by Haddock CPA on Ling Limited's financial statements, discuss the specific audit procedures that Cod CPA should carry out in respect of the balances of inventories and accounts receivables as at 1 July 20X0.

(9 marks)

(Total = 14 marks)

(HKICPA June 2012)



chapter 16

Overall audit review and finalisation

Topic list

- 1 Subsequent events**
 - 1.1 Objectives of the auditor
 - 1.2 Audit procedures
- 2 Going concern**
 - 2.1 Auditor's objectives
 - 2.2 Going concern indicators
 - 2.3 Management's responsibilities
 - 2.4 Auditor's risk assessment procedures
 - 2.5 Evaluation of management's assessment
 - 2.6 Events or conditions identified
 - 2.7 Audit reporting
- 3 Written representations**
 - 3.1 Written representations about management's responsibilities
 - 3.2 Written representations required by other HKSAs
 - 3.3 Other written representations
 - 3.4 Form of written representations
 - 3.5 Doubt about the reliability of written representations
 - 3.6 Written representations substituting other audit procedures
 - 3.7 Written representations not provided
- 4 Related parties**
 - 4.1 Introduction
 - 4.2 Nature of related party relationships and transactions
 - 4.3 Risk assessment procedures and related activities required
 - 4.4 Responses to risks of material misstatement associated with general related party relationships and transactions
 - 4.5 Audit procedures on significant transactions outside the normal course of business
 - 4.6 Related party with dominant influence
- 4.7** Unidentified or undisclosed related parties or significant related party transactions
- 4.8** Forming an opinion
- 4.9** Written representations and documentation
- 5 Overall review of financial statements**
 - 5.1 Compliance with accounting regulations
 - 5.2 Review for consistency and reasonableness
 - 5.3 Treatment of errors
- 6 Other information**
 - 6.1 What is other information?
 - 6.2 Access to other information
 - 6.3 Material inconsistencies
 - 6.4 Material misstatements of fact
- 7 Communicating with those charged with governance**
 - 7.1 The importance of communicating with those charged with governance
 - 7.2 Matters to be communicated by auditors to those charged with governance
 - 7.3 The communication process
- 8 Evaluation of misstatements identified during the audit**
 - 8.1 Accumulation of identified misstatements
 - 8.2 Consideration of identified misstatements as the audit progresses
 - 8.3 Evaluating the effect of uncorrected misstatements
 - 8.4 Communication and correction of misstatements
 - 8.5 Refusal to correct misstatements
 - 8.6 Obtain written representations and documentation
- 9 Following up discovery of illegal acts or fraud**
 - 9.1 HKSA 240 (Clarified)
 - 9.2 HKSA 250 (Clarified)

Learning focus

The review stage of the audit is very important. It is very important that you understand the difference between the review stage of the audit and the earlier testing stage.

These topics are related to the final stage of the audit process. At the end of the audit before issuing any auditor's report, the auditor is required to cover these areas.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
2.09	Audit procedures	3
2.09.10	Discuss the audit procedures and identify procedures for the audit of:	
2.09.10.05	Related party transactions	
2.12	Completion procedures	3
2.12.01	Explain the purpose of, and the procedures to be used in:	
2.12.01.01	A subsequent events review	
2.12.01.02	A going concern review	
2.12.01.03	Obtaining written representations from management	
2.12.01.05	Overall review of the financial statements	
2.12.01.06	Review of other published information	
2.12.02	Explain the procedures required to identify and audit related party transactions	
2.12.03	Explain the need to evaluate misstatements identified during the audit	
2.12.04	Explain the follow up on illegal acts or fraud found while performing an audit especially in the case of money laundering or corruption	
2.13	Reporting	3
2.13.02	Explain the requirement for an auditor to report to management or those charged with governance	

1 Subsequent events



Topic highlights

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report and also include facts discovered after the auditor's report has been issued. Auditors shall consider the effect of such events on the financial statements and on their audit opinion.



Key term

Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

HKSA 560.5e

1.1 Objectives of the auditor

HKSA 560.4

HKSA 560 (Clarified) *Subsequent Events* provides guidance to auditors in this area. The objectives of the auditor are described below:

- (a) To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need **adjustment or disclosure** in the financial statements are appropriately reflected in the financial statements in accordance with the applicable financial reporting framework
- (b) To respond appropriately to facts that become known to the auditor after the date of the auditor's report which may have caused the auditor to amend the auditor's report if they were known to the auditor at the date of the report

1.1.1 Dates



Key terms

Date of the financial statements is the date of the end of the latest period covered by the financial statements.

Date of the auditor's report is the date the auditor dates the report on the financial statements in accordance with HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements*. This date cannot be earlier than the date on which the auditor has obtained sufficient appropriate audit evidence for forming the audit opinion and the date of approval of the financial statements.

Date the financial statements are issued is the date that the auditor's report and audited financial statements are made available to third parties.

HKSA
560.5a, 5c

The date of approval of the financial statements is the date on which all the statements that comprise the financial statements have been prepared and responsible parties have asserted that they have taken this responsibility.

The **date the financial statements are issued** is the date that the auditor's report and audited financial statements are made available to third parties. This date must not only be at, or later than, the date of the auditor's report but must also be at, or later than, the date the auditor's report is provided to the entity.

1.1.2 Adjusting and non-adjusting events

HKAS 10 *Events After the Reporting Period* deals with the treatment in the financial statements of events, both favourable and unfavourable, occurring between the date of the financial statements and the date of the financial statements are issued.

There are two types of event defined by HKAS 10 *Events after the Reporting Period*:

- (a) Those that provide evidence of conditions that existed at the year-end date (**adjusting events**). These subsequent events have a direct effect on the financial statements, therefore requiring adjustments of the financial statements.
- (b) Those that are indicative of conditions that arose after the year-end date (**non-adjusting events**). These subsequent events have no direct effect on the financial statements, therefore would not require adjustment of the financial statements. However, disclosure is necessary if their non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.

You should be familiar with adjusting and non-adjusting events from your financial reporting studies. Here are some examples:

Examples of subsequent events	
Adjusting events	Non-adjusting events
Settlement of a court case	Equity dividends declared after the year-end
Sale of inventory after year-end providing evidence of its net realisable value at year-end	Fire causing destruction of plant
Fraud or error showing the financial statements are incorrect	Announcement of a major restructuring or acquisition of another enterprise
Declaration of bankruptcy due to the deteriorating financial condition of a customer with a large outstanding receivable balance	Decline in market value of securities held for temporary investment or resale
Subsequent collection of a large accounts receivable which had appeared doubtful of collection at the date of the financial statements	Disposal after the date of the financial statements of a large portion of the entity's productive assets

1.2 Audit procedures



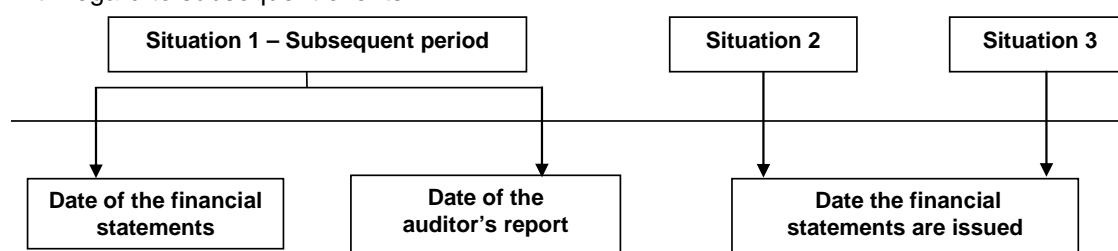
Topic highlights

Auditors have a **responsibility to identify subsequent events** before they sign their auditor's report. Action may need to be taken if they become aware of subsequent events occurring between the date they sign their auditor's report and the date the financial statements are issued.

HKSA 560.6-17

The audit procedures to identify subsequent events should be timed to occur **as near as practicable to the date of the auditor's report**. HKSA 560 (Clarified) gives guidance on the additional procedures the auditor should perform if aware of a subsequent event which materially affects the financial statements. The auditor should review whether the events are properly accounted for and adequately disclosed but need not repeat or perform further procedures on matters on which he is already satisfied.

The timeline along with the commentary given below may clarify the responsibilities of an auditor with regard to subsequent events:



1.2.1 Situation 1: Events occurring between the date of the financial statements and the date of the auditor's report

The auditor **has the responsibility** to perform audit procedures to obtain sufficient appropriate audit evidence for any subsequent events up to the date of the auditor's report if they may require adjustment of, or disclosure in, the financial statements. HKSA 560 (Clarified) lists the procedures used to identify subsequent events that are likely to result in a requirement for an adjustment or disclosure.

These procedures should be applied to any matters examined during the audit which may be susceptible to change after the reporting date. They supplement tests on specific transactions after the period end, such as cut-off tests.

Audit procedures to test subsequent events

Inquiries of management or those charged with governance

Inquire as to status of items involving **subjective judgment**.

Confirm status of items accounted for using **preliminary or inconclusive** data or unusual adjustments.

Investigate whether there are any new **commitments, borrowings or guarantees**.

Investigate whether there have been any:

- **sales** or destruction of non-current **assets**
- **issues** of **shares/debentures** or changes in business structure
- **developments** involving high **risk areas, provisions** and **contingencies**
- **unusual accounting adjustments**
- **major events** (eg going concern problems) affecting appropriateness of accounting policies for estimates
- **litigation** or claims to indicate potential contingent liabilities
- significant **changes in the assets or capital structure of the entity**

Other procedures

Review management procedures for identifying subsequent events to ensure that management are aware of the risks.

Perform procedures which usually form part of the verification of year-end account balances. These procedures include **cut-off and valuation tests** of various balances and related transactions.

Review internal documents such as board and committee meeting minutes, inquire about unusual items.

Review latest available interim financial statements and budgets, cash flow forecasts and other management reports.

Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims:

Audit procedures to test subsequent events

Obtain evidence concerning any litigation or claims from the entity's counsel (but only with the entity's permission). This may include correspondence with or confirmation letters from lawyers.

Obtain **written representation** that all events occurring subsequent to the date of the financial statements which need adjustment or disclosure have been adjusted or disclosed.

1.2.2 Situation 2: Facts discovered after the date of the auditor's report but before the financial statements are issued

As you should now be aware, the preparation of the financial statements in accordance with the appropriate accounting framework is **management's responsibility**. Therefore, management should inform the auditors of any material subsequent events between the date of the auditors' report and the date the financial statements are issued. The auditors do *not* have any obligation to perform procedures, or make inquiries regarding the financial statements, **after** the date of their auditor's report.

However, if a matter comes to the auditor's attention that had it been known to the auditor earlier may have led to a different opinion, the auditor shall:

- (a) **discuss** the matter with management and those charged with governance
- (b) **determine** whether the financial statements require **amendment**
- (c) if amendment is needed, **inquire** as to how management intends to address this. The auditors will then consider performing and extending procedures up to the date of the new auditor's report based on amended financial statements. The new auditor's report should not be dated earlier than the date of approval of the amended financial statements.

However, if management **does not amend** the financial statements the auditor has to take action to either modify or prevent reliance on the report:

- (a) If the auditor's report has not yet been provided to the entity, the auditor shall **modify the opinion** and issue its report based on that opinion emphasising the reason for qualification.
- (b) If the auditor's report has already been provided to the entity, the auditor shall advise management and those charged with governance **not to issue** the financial statements before the amendments are made. If the entity refuses, the auditor shall take action to seek to **prevent reliance** on the auditor's report. The precise action taken will depend on the auditor's legal rights and obligations and the advice of the auditor's legal counsel.

1.2.3 Situation 3: Facts discovered after the financial statements have been issued

Auditors have **no obligations** to perform procedures or make inquiries regarding the financial statements **after** they have been issued.

However, if the auditor becomes aware of a fact that had it been known to the auditor at the date of the auditor's report, may have led to a different outcome, the auditor shall follow the steps outlined in Situation 2, that is discussion with management, assessing whether the statements need amendment and how that might be addressed.

If management amends the financial statements, the auditor shall carry out and extend procedures necessary up to the date of the new auditor's report. The auditor will also review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements is **informed** that an amended set of financial statements has been issued and that the reasons why are adequately disclosed.

The auditor shall also issue a **new or amended auditor's report** which will include an **explanatory paragraph** (known as an **emphasis of matter paragraph or other matter paragraph**) that refers to a note in the financial statements that discusses the reason for the amendment.

In our opinion, the revised financial statements give a true and fair view, as at the date the original financial statements were approved, of the financial position of the company as of 31 December 20X0, and of its profits and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards.

In our opinion the original financial statements for the year to 31 December 20X0, failed to comply with the Hong Kong Companies Ordinance.

Date

AUDITOR

Address

If the auditors feel management has failed to adequately communicate the fact that the financial statements have been amended to users, the auditor shall **notify** management and those charged with governance that the auditor will **seek to prevent future reliance** on the report through legal recourse.

In the public sector, when management does not amend the financial statements, auditors may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report.



Self-test question 1

As at 31 December 20X9, Slow Moving Company Limited ("SMC") has trade receivables of HK\$30,000,000 overdue for more than one year. After some rounds of tough negotiation with the auditor, SMC finally agreed to write-off the whole amount in its draft financial statements for the year ended 31 December 20X9, since it failed to convince the auditor that the debts are recoverable. However, one of the debtors settled an amount of HK\$8,000,000 a few days before SMC's directors are due to approve the financial statements. The directors of SMC prefer not to amend the financial statements to reflect the settlement of the overdue amount of HK\$8,000,000, and account for the impairment reversal in the year ending 31 December 20Y0. You are the engagement manager for the audit of SMC's financial statements for the year ended 31 December 20X9.

Required

- (a) Determine your team's responsibility to identify the settlement of the overdue amount of HK\$8,000,000; and

(9 marks)

- (b) Determine your team's response if your team becomes aware of the settlement before your firm issues the auditor's report.

(3 marks)

(Total = 12 marks)

HKICPA February 2010 (amended)

(The answer is at the end of the chapter)

2 Going concern



Topic highlights

If the entity has inappropriately used the going concern assumption or a material uncertainty exists, this may impact on the auditor's report.



Key term

HKSA 570.2

Under the **going concern assumption**, an entity is viewed as continuing in business for the foreseeable future with neither the intention to liquidate or cease trading. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

2.1 Auditor's objectives

HKSA 570.9

HKSA 570 (Clarified) *Going Concern* provides guidance to auditors in this area. The objectives of the auditor are to:

- (a) obtain sufficient appropriate audit evidence regarding the **appropriateness** of management's use of the going concern assumption
- (b) conclude whether a **material uncertainty** exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
- (c) determine the **implications** for the auditor's report

2.2 Going concern indicators

HKSA 570.A2

HKSA 570 (Clarified) includes examples of events or conditions that may cast doubt about the going concern assumption (going concern indicators). These fall under three headings: "financial", "operating" and "other", and are shown in the table below:

Events or conditions that may cast doubt about the going concern assumption

Financial	<ul style="list-style-type: none"> • Net liability or net current liability position • Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment • Excessive reliance on short-term borrowings to finance long-term assets • Withdrawal of financial support by creditors, holding entity and shareholders • Negative operating cash flows • Adverse key financial ratios • Substantial operating losses or significant deterioration in the value of assets used to generate cash flows • Arrears or discontinuance of dividends • Inability to pay creditors on due dates • Inability to comply with terms of loan agreements • Change from credit to cash-on-delivery transactions with suppliers • Inability to obtain financing for essential new product development or other essential investments
Operating	<ul style="list-style-type: none"> • Management intentions to liquidate or cease operations • Loss of key management without replacement • Loss of a major market, key customers, licence, or principal suppliers • Labour difficulties • Shortages of important supplies • Emergence of a highly successful competitor
Other	<ul style="list-style-type: none"> • Non-compliance with capital or other statutory requirements • Pending legal or regulatory proceedings against the entity • Changes in law or regulations that may adversely affect the entity • Uninsured or under-insured catastrophes when they occur

The significance of the above events or conditions can be mitigated by other factors, for example:

- (a) An inability to make normal debt repayments may be counter-balanced by management's plans to sell assets, rescheduling loan repayments, or obtaining additional capital.
- (b) The loss of a principal supplier may be counter-balanced by the availability of a suitable alternative source of supply.

2.3 Management's responsibilities

It is management's responsibility to make assessment of whether the entity can continue as a going concern, not the auditor's responsibility.

When management is aware of material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern, **uncertainties should be disclosed**.

Management's assessment must cover **a period of not less than 12 months from the date of the financial statements**. If it is less than 12 months, the auditor should ask management to **extend its assessment**. The auditor shall cover the same period as performed by the management, or by law or regulation if it specifies a longer period.

If the entity has a **history of profitable operations** and has **sufficient financial resources** for its operations, management is not required to make a detailed assessment provided the auditor can carry out detailed procedures.

The auditor shall also inquire of management their knowledge of events or conditions beyond the period of the assessment that may cast significant doubt on the entity's ability to continue as a going concern.

When management makes the assessment, it will consider the following:

- The **uncertainty** involved about the events and conditions being assessed
- **Judgment** made based in the available information at that time and the future (eg subsequent events can contradict a judgement which was reasonable at the time it was made)
- The size and complexity of the entity, the nature and condition of the business.

2.4 Auditor's risk assessment procedures

When performing risk assessment procedures as required by HKSA 315 (Revised), 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**. In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

- (a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them.
- (b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption, and enquire of management whether events or conditions exist that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern.

HKSA 570.10

These risk assessment procedures assist the auditor to determine whether management's use of the going concern assumption is likely to be an important issue and has major impact in the audit planning. Auditors may discuss with management its plans and resolution of any identified going concern issues.

The auditor shall **remain alert** throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

2.5 Evaluation of management's assessment

2.5.1 The period of management's assessment

HKSA
570.12-15

According to HKSA 570 (Clarified), the auditor shall evaluate management's assessment of the entity's ability to continue as a going concern and management's use of the going concern assumption.

The auditor shall consider whether management's assessment includes all relevant information for the auditor's evaluation. In addition, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable reporting framework, that is HKAS 1 (Revised) or by law or regulation if it is specifically a longer period.

As mentioned previously, management's assessment must cover **a period of not less than 12 months from the date of the financial statements**. If management is unwilling to extend its assessment as requested the auditors shall consider the implications for their report.

2.5.2 Period beyond management's assessment

HKSA 570 (Clarified) requires that the auditor shall inquire of management as to its knowledge of events or conditions beyond the period of a management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. The auditors have **no responsibility** to perform other audit procedures apart from inquiry.

In case there are events and conditions identified, the auditor may need to request management to evaluate the potential significance of the event or condition on management assessment.

The auditor shall consider the degree of uncertainty associated with these events and conditions before considering taking further actions.

2.6 Events or conditions identified

HKSA
570.16, A15-
A18

If events or conditions are **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**, including consideration of **mitigating factors**.

These procedures required under HKSA 570 (Clarified) follow:

- Requesting management to make its **assessment** where this has not been done
- Confirming the existence of the material uncertainty
- Evaluating management's **plans for future actions**
- Evaluating the **reliability of underlying data** used to prepare a cash flow forecast and considering the **assumptions** used to make the forecast
- Considering whether any **additional facts or information** have become available since the date management made its assessment such as **interim financial statements**, board minutes, correspondence with lawyers
- **Inquiring** of the entity's legal counsel regarding **litigation and claims**
- Reviewing subsequent events affecting going concern
- **Analysing and discussing cash flow**, profit and other relevant forecasts with management
- Confirming financial support and their ability to provide the support from shareholders, creditors or related parties
- Reviewing terms of debenture or bank loans and whether there are any breaches
- Requesting **written representations** from management and those charged with governance about plans for future action and the feasibility of these plans
- Confirming the existence, terms and adequacy of **borrowing facilities**
- Obtaining and reviewing reports of **regulatory actions**
- Determining the adequacy of **support for any planned disposal of assets**

Based on the evidence obtained, the auditor should determine if a material uncertainty exists related to the events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If it is **material**, the financial statements should adequately describe the principal events or conditions that give rise to the uncertainty about the continuance as a going concern and management's plan to deal with it.

2.7 Audit reporting

HKSA
570.17-22

HKSA 570 (Clarified) requires that the auditor shall conclude whether, in the auditor's judgment, a **material uncertainty** exists related to events or conditions which may cast doubt on the entity's ability to continue as a going concern.

A material uncertainty exists when the magnitude of its **potential impact and likelihood** of occurrence is such that, in the auditor's judgment, **appropriate disclosure** of the nature and implications of the uncertainty is necessary.

2.7.1 Use of going concern appropriate but a material uncertainty exists

If adequate disclosures are made in the financial statements of the following:

- Principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
- Management's plans to deal with these events or conditions
- That a material uncertainty exists ("material uncertainty" is used in HKAS 1 (Revised) in discussing the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements).
- The entity may be unable to realise its assets and discharge its liabilities in the normal course of business

the auditor shall express an **unmodified opinion and include an emphasis of matter paragraph** in the auditor's report to:

- (a) highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to
- (b) draw attention to the note in the financial statements that discloses the matter.

The following is an illustration of an emphasis of matter paragraph:

Emphasis of matter

Without qualifying our opinion, we draw attention to Note 5 in the financial statements which indicates that the Company incurred a net loss of HK\$10,000,000 during the year ended 31 December 20X0 and, as of that date, the Company's current liabilities exceeded its total assets by HK\$15,000,000. These conditions, along with other matters as set forth in Note 3, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

For multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate to express a **disclaimer of opinion** instead.

2.7.2 Appropriate use of going concern assumption but inadequate disclosure

If the auditor concludes that the use of the going concern assumption is appropriate but a material uncertainty exists and there is inadequate disclosure in the financial statements, the auditor shall express a qualified opinion or adverse opinion in accordance with HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report*.

The following is an illustration of the relevant paragraphs when a qualified opinion is to be expressed:

Basis for qualified opinion

The Company's financing arrangements expire and amounts outstanding are payable on 19 March 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Qualified opinion

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X0 and of its financial performance and its cash flows for the year then ended in accordance with...

2.7.3 Inappropriate use of going concern assumption

If the financial statements have been prepared on a going concern basis, but in the auditor's judgment this is **inappropriate**, the auditor must express **an adverse opinion**. This applies regardless of whether the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption.

The following is an illustration of the relevant paragraphs when an adverse opinion is to be expressed:

Basis for adverse opinion

The Company's financing arrangements expired and amounts outstanding are payable on 31 December 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Adverse opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view of the financial position of the Company as at 31 December 20X0, and of its financial performance and its cash flows for the year then ended in accordance with ...

2.7.4 Management unwilling to make or extend its assessment

In certain circumstances, the auditor may believe it necessary to **request management to make or extend its assessment**. If management is unwilling to do so, **a qualified opinion or a disclaimer of opinion** in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding the use of the going concern assumption in the preparation of the financial statements.

2.7.5 Preparation of financial statements on an alternative basis

If the entity's management is required or elects to prepare financial statements where the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an **alternative basis** such as the liquidation basis. The auditor can still perform the audit provided that the auditor determines the alternative basis is an acceptable financial reporting framework in the circumstances.

The auditor can still issue an **unmodified opinion** on those financial statements if adequate disclosure has been made and an **emphasis of matter paragraph** may be added to draw reader's attention to that alternative basis and the reasons for its use.

2.7.6 Summary of reporting on going concern

The following table summarises the possible scenarios that could arise following the auditor's review of going concern:

Scenario	Impact on auditor's report
Going concern assumption appropriate but material uncertainty which is adequately described and disclosed	Unmodified opinion and emphasis of matter paragraph
Going concern assumption appropriate but material uncertainty which is not adequately disclosed	Qualified or adverse opinion
Use of going concern assumption inappropriate	Adverse opinion
Management unwilling to make or extend its assessment	Qualified or disclaimer of opinion

The auditor shall communicate with those charged with governance events or conditions that may cast doubt on the entity's ability to continue as a going concern. This will include:

- whether the events or conditions constitute a material uncertainty
- whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements
- the adequacy of related disclosures



Self-test question 2

Elegant Ella Limited ("EE") is a garment manufacturer with major overseas customers residing in the US. Its annual turnover exceeds US\$500 million.

You are the auditor of EE. In March 20X2, you have substantially completed your audit work of the financial statements for the year ended 31 December 20X1 and are satisfied that there are no material misstatements. You intend to conclude the audit by 15 April 20X2. On 2 April 20X2, the Wall Street Journal has reported on the serious financial difficulty of EE's largest customer, Y Limited. According to the report, the customer may declare bankruptcy any time.

Required

- In view of the facts and the news report, what is your revised assessment of the risk of material misstatement of EE's financial statements as a whole? **(4 marks)**
- In response to the circumstances, what are the further audit procedures, with reasoning, you would design to complete your audit and to give an audit opinion on EE's financial statements for the year ended 31 December 20X1? **(9 marks)**

(Total = 13 marks)

HKICPA December 2011

(The answer is at the end of the chapter)

3 Written representations



Topic highlights

The auditor obtains **written representations** from management and, where appropriate those charged with governance, concerning their responsibilities and to support other audit evidence where necessary.



Key term

Written representations are written statements by management provided to the auditor to confirm certain matters or to support other audit evidence. They do not include the financial statements, assertions or supporting books and records.

HKSA 580.7

HKSA 580.6

HKSA 580 (Clarified) *Written Representations* provides guidance to auditors in this area. The objectives of the auditor are described below:

- (a) To obtain written representations from management that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor
- (b) To support other audit evidence relevant to the financial statements if determined necessary by the auditor or required by other HKSAs
- (c) To respond appropriately to written representations or if management does not provide written representations requested by the auditor

3.1 Written representations about management's responsibilities

HKSA
580.10, 11

The auditor shall request management to provide written representations on the following matters:

- (a) That management has fulfilled its responsibility for the **preparation and presentation of the financial statements** as set out in the terms of the audit engagement and whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework ie HKASs and HKFRSs – management acknowledges its responsibility
- (b) That management has provided the auditor with all **relevant information** agreed in the terms of the audit engagement
- (c) All transactions have been recorded and are reflected in the financial statements

During the audit, the auditor makes **inquiries of management**. It is important for auditor to document management's representations where they are critical to obtaining audit evidence. The normal practice is auditors would receive a signed copy of the financial statements with a relevant statement of management responsibilities.

3.2 Written representations required by other HKSAs

HKSA 580 (Clarified) sets out a list of other HKSAs that require specific written representations and the following illustrates the content of this list.

HKSA 240 (Clarified) <i>The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements</i>	<p>Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance to evidence the following:</p> <ul style="list-style-type: none"> (a) acknowledgement of their responsibilities for the design, implementation and maintenance of internal control to prevent and detect fraud (b) disclosure to the auditor of the results of management's assessment of the risk that the financial statements may be materially misstated due to fraud (c) disclosure to the auditor of their knowledge of fraud or suspected fraud affecting the entity or knowledge of an allegation of fraud.
HKSA 250 (Clarified) <i>Consideration of Laws and Regulations in an Audit of Financial Statements</i>	<p>Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their disclosure of known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.</p>
HKSA 450 (Clarified) <i>Evaluation of Misstatements Identified During the Audit</i>	<p>Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their belief that the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.</p>
HKSA 501 (Clarified) <i>Audit Evidence – Specific Considerations for Selected Items</i>	<p>Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance that disclosure has been made to the auditor of their knowledge of actual or possible litigation and claims whose effects should be considered when preparing the financial statements.</p>
HKSA 540 (Clarified) <i>Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures</i>	<p>Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their belief that significant assumptions used in making accounting estimates are reasonable.</p>
HKSA 550 (Clarified) <i>Related Parties</i>	<p>Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their:</p> <ul style="list-style-type: none"> (a) disclosure to the auditor of the identity of the entity's related parties and all the related party relationships and transactions of which they are aware (b) actions of having appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework

HKSA 560 (Clarified) <i>Subsequent Events</i>	Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their belief that all events occurring subsequent to the date of the financial statements, for which the applicable financial reporting framework requires adjustment or disclosure, have been adjusted or disclosed.
HKSA 570 (Clarified) <i>Going Concern</i>	Requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their plans for future action and the feasibility of these plans.
HKSA 710 (Clarified) <i>Comparative Information – Corresponding Figures and Comparative Financial Statements</i>	Requires that the auditor shall: <ul style="list-style-type: none"> (a) request written representations for all periods referred to in the auditor's opinion (b) obtain specific written representations regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.

3.3 Other written representations

HKSA 580.13

Apart from Section 3.2, the auditor **shall obtain other representations** ie one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

3.4 Form of written representations

HKSA 580.15

The written representations shall be in the form of a representation **letter**.

The representation letter should:

- be addressed to the auditors
- be appropriately dated (see below)
- contain specific information
- be signed by the members of management who have primary responsibility for the entity and with specific relevant knowledge

The date of the written representations shall be **as near as practicable to, but not after, the date of the auditor's report on the financial statements**. The written representations shall be for all the financial statements and periods referred to in the auditor's report.

3.5 Doubt about the reliability of written representations

HKSA 580.16-18, 20

Written representations are the confirmations of oral representations from management to avoid any confusion and disagreement. The written representation letter is written evidence, so is better quality evidence than oral representations.

However, the letter is evidence from within the entity and is less reliable than information from independent sources. It is crucial to note that the auditor **cannot solely rely on written representations** from management or those charged with governance as they are from an internal source. The HKSA stresses that written representations **do not provide sufficient appropriate audit evidence on their own**. The auditor shall consider the competence, integrity, ethical values of management as these factors would affect the reliability of these written representations.

If written representations are **inconsistent** with other internal and external corroborative audit evidence, the auditor shall perform audit procedures to try to **resolve the matter** or **investigate** the circumstances. If the matter cannot be resolved, the auditor shall reconsider the assessment of the competence, integrity and ethical values of management, and the effect this may have on the reliability of representations and audit evidence in general.

If the auditor concludes that written representations are **not reliable**, the auditor shall take appropriate actions, including determining the impact on the auditor's report or withdrawing from the engagement.

HKSA 580 (Clarified) requires that the auditor shall disclaim an opinion on the financial statements if the auditor concludes that there is sufficient doubt about the integrity of management.

3.6 Written representations substituting other audit procedures

Representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example:

- (a) A representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain
- (b) A representation by management as to the quantity and condition of inventories is not a substitute for the same evidence obtained through physical observation
- (c) A representation by management as to the existence of a trade receivable is not a substitute for the same evidence obtained by trade receivable confirmation

3.7 Written representations not provided

HKSA
580.19, 20

If management refuses to provide representations that the auditor requires, this constitutes a **limitation on scope** and auditor should express a **qualified opinion or a disclaimer of opinion**. The auditor should reconsider the appropriateness of relying on other management representations during the audit and should discuss the matter with management. Auditors should **re-evaluate** the integrity of management.



Self-test question 3

Towards the end of an audit, it is common for the external auditor to seek a letter of representation from the management of the client company.

Required

- (a) List the matters commonly included in the letter of representation.
- (b) Explain why it is important to discuss the content of the letter of representation at an early stage during the audit.

(The answer is at the end of the chapter)

4 Related parties



Topic highlights

It can be difficult to gain audit evidence about related party transactions.

4.1 Introduction

HKSA 550 (Clarified) *Related Parties* deals with the auditor's responsibilities with regards to related party relationships and transactions in an audit of financial statements. It is **management's responsibility** to identify related party transactions, to make proper disclosure and to approve the transactions. It is not the auditor's responsibility to do so.

4.2 Nature of related party relationships and transactions



Key term

Related party. A party that is either:

- (a) a related party as defined in the applicable financial reporting framework (eg HKAS 24 (Revised)).
- (b) where the applicable financial reporting framework establishes minimal or no related party requirements:
 - (i) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity.
 - (ii) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries.
 - (iii) Another entity that is under common control with the reporting entity through having:
 - common controlling ownership (ie parent, subsidiary or fellow subsidiary related)
 - owners who are close family members
 - common key management

HKSA 550.10

HKSA 550.2

During the audit process, auditors often encounter difficulties in identifying related party transactions.

The **nature** of related party relationships and transactions may give rise to **increased risk** due to the following reasons:

- (a) Related parties may operate through a **wide** and **complex** range of relationships and structures ie complex group structures. Management may be unaware of the existence of all related party relationships and transactions
- (b) **Information systems may be ineffective** at identifying or summarising transactions and outstanding balances between an entity and its related parties
- (c) Related party transactions may not be conducted under **normal market terms and conditions**
- (d) Related party relationships provide a greater opportunity for **collusion, concealment or manipulation** by management
- (e) Identifying related party transactions means **extra work** for management as often accounting systems are not designed to identify the related party transactions
- (f) Often there is a **lack of audit trail** for related party transactions

Planning and performing the audit with **professional scepticism** is therefore particularly important where there are related parties.

4.2.1 Obtaining an understanding of the control environment

The auditor may consider features of the control environment relevant to mitigating the risks of material misstatements associated with related party relationships and transactions. For example:

- (a) Review entity's internal codes
- (b) Communicate appropriately with those charged with governance within the entity
- (c) Review policies and procedures for disclosure of related party transactions, especially those involving management and those charged with governance
- (d) Consider the personnel assigned within the entity for identifying, recording, summarising and disclosing related party transactions
- (e) Consider timely disclosure and discussion between management and those charged with governance in related to significant related party transactions
- (f) Consider clear guidelines and monitoring controls of authorisation of related party transactions and the terms and arrangements of these transactions
- (g) Consider any periodic reviews by the entity's internal auditors
- (h) Consider proactive action taken to resolve related party disclosure issues
- (i) Consider the existence of monitoring controls over the related party transactions

4.2.2 The entity's controls over related party transactions

The auditor shall inquire of management and others within the entity, and perform **other risk assessment procedures** considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- (a) identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework
- (b) authorise and approve significant transactions and arrangements with related parties
- (c) authorise and approve significant transactions and arrangements outside the normal course of business

Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. Examples include those charged with governance, internal auditors, in-house legal counsel and the Chief Ethics Officer.

Sometimes, **controls** over related party relationships and transactions may be **deficient or non-existent** as:

- (a) management considers the controls are less important
- (b) there is lack of appropriate oversight by those charged with governance
- (c) management intends to disregard such controls in order to conceal sensitive information
- (d) management has an insufficient understanding of the requirements of the applicable financial reporting framework

The auditor may have to consider the ability to obtain sufficient appropriate audit evidence about related party relationships and transactions and shall consider the impact on the auditor's report.

4.3 Risk assessment procedures and related activities required

HKSA
550.12, 13, 15

According to HKSA 550 (Clarified), the auditor shall perform audit procedures and related activities to obtain information relevant to identifying the risks of material misstatement required by HKSA 315 (Revised) and HKSA 240 (Clarified) associated with related party relationships and transactions.

In addition, HKSA 550 (Clarified) requires the engagement team to **discuss** the susceptibility of the entity's financial statements to material misstatement due to fraud or error that may result from related party relationships and transactions.

4.3.1 Inquire of management and others within the entity

The auditor shall inquire of management the following:

- The identity of the entity's related parties
- The relationships between the entity and these related parties
- The types and the purposes of these related party transactions

4.3.2 Reviewing records or documents

During the audit, the auditor shall remain **alert**, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

In particular, the auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:

- Bank and legal confirmations obtained as part of the auditor's procedures
- Minutes of meetings of shareholders and of those charged with governance
- Such other records or documents as the auditor considers necessary in the circumstances of the entity

Examples of records or documents that the auditor **may inspect** in addition to those required include the following:

- Third-party confirmations obtained by the auditor (in addition to bank and legal confirmations)
- Entity income tax returns
- Information supplied by the entity to regulatory authorities
- Shareholder registers to identify the entity's principal shareholders
- Statements of conflicts of interest from management and those charged with governance
- Records of the entity's investments ie investment certificate or statements and those of its pension plans
- Contracts and agreements with key management or those charged with governance
- Significant contracts, agreements or accounting records not in the entity's ordinary course of business
- Specific invoices and correspondence from the entity's professional advisers
- Life insurance policies acquired by the entity
- Significant contracts re-negotiated by the entity during the period
- Internal auditors' reports
- Documents associated with the entity's filings with a securities regulator
- Entity records ie annual returns
- Prior year working papers

Auditors shall **share all relevant information** obtained about the entity's related parties with the other members of the engagement team.

4.4 Responses to risks of material misstatement associated with general related party relationships and transactions

HKSA 550.20

Depending upon the results of the auditor's risk assessment, the auditor should **modify the nature, extent and timing** of the audit procedures to respond to the assessed risks associated with related party relationships and transactions.

4.4.1 Testing controls over related party transactions

The auditor should consider whether it is possible to obtain sufficient appropriate audit evidence from substantive audit procedures alone or test the entity's controls over related party relationships and transactions. The auditor may find it **more effective to perform tests of controls when transactions are initiated, recorded, processed or reported electronically in an automatic system**. As a result, the auditor is required to test the entity's controls over the completeness and accuracy of the recording of the related party relationships and transactions.

The auditor should design and perform **further audit procedures** to obtain **sufficient appropriate audit evidence** about the assessed risks of material misstatement associated with related party relationships and transactions. The nature, timing and extent of these procedures depend on the nature of the risks and the circumstances of the entity.

4.5 Audit procedures on significant transactions outside the normal course of business

HKSA 550.23

If the auditor identifies **significant transactions** outside the entity's normal course of business, the auditor shall inquire of management about:

- (a) the **nature** of these transactions
- (b) whether related parties could be involved

In addition, the auditor shall understand the **business rationale of the transactions** and the **terms and conditions** under which these have been entered into and shall consider whether any fraud exists.

4.5.1 Transactions outside the entity's normal course of business

- (a) Transactions outside the entity's normal course of business may include the following:
 - (i) Complex equity transactions
 - (ii) Use of tax haven companies
 - (iii) Transactions with no consideration exchanged
 - (iv) Sales transactions with unusually large discounts or returns or abnormal terms such as unusual prices, interest rates and guarantees
 - (v) High volume or significant transactions that involve only one single party
 - (vi) Transactions with circular arrangements
 - (vii) Transactions under **contracts whose terms are changed before expiry**
- (b) For identified significant related party transactions outside the entity's normal course of business, the auditor shall perform the following:
 - (i) **Inspect** the underlying contracts or agreements
 - (ii) **Evaluate** whether the **business rationale** of the significant related party transactions suggests they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets

Business rationale considerations include the following: underlying complexity, the terms of trade, the logical business reason and the manner of process.

- (iii) **Evaluate** whether the terms of the transactions are consistent with management's explanations
- (iv) **Evaluate** whether the transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework
- (v) **Obtain audit evidence** that the significant related party transactions have been appropriately **authorised and approved**

The auditor shall consider the **consistency** between management's explanations and the business rationale of the related party transactions. Any inconsistencies with the nature of its business may indicate a fraud risk.

The auditor shall consider and be alert as to whether there are **rational explanations** for significant related party transactions that have **not been authorised and approved** by appropriate level of management. Even where the transactions have been authorised and approved, the auditor shall consider whether there is collusion between the related parties or by related parties with dominant influence.

The auditor shall **identify** and **assess** the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are **significant risks**.

4.5.2 Substantive procedures in response to significant risks

When the auditor has assessed a significant risk that management has not appropriately accounted for or disclosed those specific related party transactions in accordance with the applicable financial reporting framework, the auditor shall perform the following substantive procedures:

- Confirm or discuss these transactions with intermediaries ie banks or legal firms
- Confirm the purposes, terms or amounts of these related party transactions
- Read the financial information or statements of related parties, if applicable

4.6 Related party with dominant influence



Topic highlights

A related party with dominant influence can **exert control or dominant influence** over the entity or its management.

4.6.1 Indicators of dominant influence

This is necessary for identifying and assessing the risks of material misstatement due to **fraud**. Such domination of management by a single person or small group of persons without any compensating controls is a **fraud risk factor**.

Indicators of dominant influence exerted by a related party include:

- (a) significant transactions are referred to the related party for final approval
- (b) the related party has banned significant business decisions taken by management and those charged with governance
- (c) no debates by management and those charged with governance on the proposal initiated by the related party
- (d) no approval or independent review of related party transactions
- (e) leading the entity by exerting dominant influence

The auditor should be aware of any significant risks of material misstatement due to fraud such as:

- (a) high turnover of senior management indicating unethical or fraudulent business practices
- (b) use of intermediaries for significant related party transactions that have no clear business justification
- (c) excessive participation by related parties, especially in making significant estimates

4.6.2 Audit procedures on significant risks of material misstatement due to fraud

If the auditor has determined there is a significant risk of material misstatement due to fraud because of the presence of a related party with dominant influence, the auditor may perform the following audit procedures:

- Inquire of management, or those charged with governance, or the related party
- Inspect significant contracts with related party
- Perform background research
- Review employee whistle-blowing reports

4.7 Unidentified or undisclosed related parties or significant related party transactions

HKSA
550.21, 22

HKSA 550 (Clarified) requires that if entity's management has not previously identified or disclosed to the auditors the existence of related party relationships or transactions, the auditor shall determine and confirm whether these transactions do really exist.

If management has not previously identified or disclosed to the auditors the related parties or significant related party transactions and the auditor has identified them by himself, the auditor shall:

- communicate promptly with other members of the engagement team
- request management to identify these transactions for auditor's further evaluation
- inquire of the entity about the controls over the related party relationships and transactions
- inquire of management the reasons for failure to identify and disclose these transactions
- inquire of parties outside the entities who have presumed knowledge of the entity ie lawyers or consultants
- analyse the accounting records and verify the terms and conditions of these transactions
- consider the implication for the audit, especially concerning fraud

4.8 Forming an opinion

HKSA 550.27

In forming an opinion on the financial statements the auditor must evaluate whether:

- (a) the identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework
- (b) the effects of the related party relationships and transactions:
 - (i) prevent the financial statements from achieving fair presentation (for fair presentation frameworks)
 - (ii) cause the financial statements to be misleading (for compliance frameworks)

If the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties or related party transactions and the disclosure is not adequate, the auditor should modify the auditors' report.

The auditor must **communicate** all significant matters arising during the audit in connection to the entity's related parties **to those charged with governance**.

4.9 Written representations and documentation

HKSA 550.26

Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

- (a) they have disclosed to the auditor the identity of the entity's related parties and **all** the related party relationships and transactions of which they are aware (**completeness**)
- (b) they have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework (**adequacy**)

The auditor must **document** the names of all identified related parties and the nature of the related party relationships.



Self-test question 4

You are the audit manager responsible for a recurring audit engagement. As a result of the planning procedures recently completed for the upcoming year's audit assignment, you became aware that the company purchased goods from a supplier that may be related to a director of the company.

Required

- (a) What factors may cause you to believe that the purchases were made from a related party?
- (b) What would you do if you concluded that the purchases were made from a related party?
- (c) What would you do to ensure the completeness of related party transactions?

(The answer is at the end of the chapter)

5 Overall review of financial statements



Topic highlights

The auditors must perform and document an **overall review** of the financial statements by undertaking **analytical procedures** before they can reach an opinion.

Once most of the substantive audit procedures have been carried out, the auditors will have a draft set of financial statements which should be supported by appropriate and sufficient audit evidence. Towards the end of the audit process, it is usual for the auditors to undertake an **overall review** of the financial statements.

This review of the financial statements, in conjunction with the conclusions drawn from the other audit evidence obtained, gives the auditors a reasonable basis for their opinion on the financial statements. It should be carried out by a senior member of the audit team, with appropriate skills and experience.

5.1 Compliance with accounting regulations

The auditors should consider whether:

- (a) the information presented in the financial statements is in accordance with local statutory requirements that is, the Hong Kong Companies Ordinance
- (b) the accounting policies employed are in accordance with accounting standards HKASs and HKFRSs, properly **disclosed, consistently applied and appropriate** to the entity

When examining the **accounting policies**, auditors should consider the following:

- (a) Policies **commonly adopted in particular industries**
- (b) Policies for which there is **substantial authoritative support**
- (c) Whether any **departures from applicable accounting standards** are necessary for the financial statements to give a true and fair view
- (d) Whether the **financial statements reflect the substance** of the underlying transactions and not merely their form
- (e) Whether sufficient evidence has been collected
- (f) Whether the evidence supports the auditor's opinion
- (g) Review of working papers

5.2 Review for consistency and reasonableness

The auditors should consider whether the financial statements are **consistent** with their knowledge of the entity's business and with the results of other audit procedures, and the manner of disclosure is fair. This can be done by applying **analytical procedures** at or near the end of the audit.

The principal considerations are as follows:

- (a) Whether the financial statements adequately reflect the **information and explanations** previously obtained and conclusions previously reached during the course of the audit
- (b) Whether it reveals any **new factors** which may affect the presentation of, or disclosure in, the financial statements
- (c) Whether **analytical procedures** applied when completing the audit, such as comparing the information in the financial statements with other pertinent data, **produce results** which assist in arriving at the overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the entity's business
- (d) Whether the **presentation** adopted in the financial statements may have been unduly influenced by the **directors' desire** to present matters in a favourable or unfavourable light
- (e) The potential impact on the financial statements of the **aggregate of uncorrected misstatements** (including those arising from bias in making accounting estimates) identified during the course of the audit and the preceding period's audit, if any

The analytical review at the final stage must cover:

- important accounting ratios
- related items
- changes in products/customers
- price and mix changes
- wages changes
- variances
- trends in production and sales
- changes in material and labour content of production
- other expenditure in the statement of profit or loss and other comprehensive income
- variations caused by industry or economy factors

As at other stages of the audit process, significant fluctuations and unexpected relationships must be investigated and documented in the working papers.

5.3 Treatment of errors

As part of their completion procedures, auditors should consider whether the **aggregate of uncorrected misstatements** in the financial statements is material (also see Section 8 of this chapter).

During the course of the audit, errors will be discovered which may be material or immaterial to the financial statements. It is very likely that the entity will adjust the financial statements to take account of these during the audit. At the end of the audit, however, some errors may still be outstanding and the auditors will summarise these **unadjusted errors**.

The summary of errors will not only list errors from the current year, but also those in the previous year(s). This will allow errors to be highlighted which are reversals of errors in the previous year, such as in the valuation of closing/opening inventory. **Cumulative errors** may also be shown, which have increased from year to year. It is normal to show both the effect on the statement of financial position and statement of profit or loss and other comprehensive income.

If the auditors consider that the **aggregate of misstatements may be material**, they must consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements (which management may wish to do anyway).

If management **refuses to adjust** the financial statements and the results of extended audit procedures do not enable the auditor to conclude that the aggregate of uncorrected misstatements is not material, the auditor should consider the **appropriate modification** to the auditor's report.

If the aggregate of the uncorrected misstatements that the auditors have identified approaches the materiality level, the auditors should consider whether it is likely that undetected misstatements, when taken with aggregated uncorrected misstatements, could exceed the materiality level.

Therefore, as aggregate uncorrected misstatements approach the materiality level the auditors should consider reducing the risk by:

- **performing additional audit procedures**
- **requesting management to adjust** the financial statements for identified misstatements

The schedule will be used by the audit manager and partner to decide whether the entity should be requested to make adjustments to the financial statements to correct the errors.

6 Other information



Topic highlights

Auditors should always seek to resolve **inconsistencies** or **misstatements of fact** between financial statements and other published information.

6.1 What is other information?

HKSA 720.6

HKSA 720 (Clarified) *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* sets out the requirements of the auditor with respect to other information, on which the auditors have **no obligation to report**, in documents containing financial statements. However, the auditor is required to **read** the other information to identify material inconsistencies if any with the audited financial statements.



Key terms

HKSA
720.5a, 5b

Other information is 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.

An **inconsistency** exists when other information contradicts information contained in the audited financial statements.

A **material inconsistency** may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

Here are some examples of other information:

- A report by management or the board of directors on operations
- Financial summaries or highlights
- Employment data
- Planned capital expenditures
- Financial ratios
- Names of officers and directors
- Selected quarterly data

Auditors have **no responsibility** to report that other information is properly stated because an audit is only an expression of opinion on the truth and fairness of the financial statements. However, they may be **engaged separately**, or **required by statute**, to report on elements of other information. In any case, the auditors should give consideration to other information as inconsistencies with the audited financial statements may undermine the auditor's report.

6.2 Access to other information

HKSA 720.7

Timely access to other information will be required. The auditors therefore must make appropriate arrangements with the entity to obtain such information prior to the date of the auditor's report.

6.3 Material inconsistencies

HKSA 720.8-10

If, on reading the other information, the auditor identifies a **material inconsistency**, the auditor shall determine whether the audited financial statements or the other information needs to be **revised**.

When revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in accordance with HKSA 705 (Clarified). If revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance and:

- include in the auditor's report an other matter paragraph describing the material inconsistency
- withhold the auditor's report
- where withdrawal is legally permitted, withdraw from the engagement

The actions taken by the auditors will depend on the individual circumstances and the auditors may consider taking legal advice, but may include the use of the auditor's right to be heard at the general meeting of the members.

For any material inconsistencies identified in other information obtained subsequent to the date of the auditor's report, the auditor shall follow the requirements set out in HKSA 560 (Clarified) *Subsequent Events*. (Please refer to Section 1 of this chapter.)

6.4 Material misstatements of fact

HKSA
720.14-16,
Appendix

A “**misstatement of fact**” in other information exists when such information, **not related** to matters appearing in the financial statements, is incorrectly stated and presented. A material misstatement of fact may undermine the **credibility** of the document containing audited financial statements.

If on reading the other information for the purpose of identifying material inconsistencies the auditor becomes **aware** of an apparent material misstatement of fact, the auditor shall **discuss the matter with management** and shall **evaluate the validity of the other information** and management's responses to the auditors' inquiries, and would need to consider whether valid differences of judgment or opinion exist.

When, following such discussions, the auditor still considers that there is an apparent material misstatement of fact, the auditor shall request management to **consult with a qualified third party**, such as the entity's legal counsel and the auditor shall consider the advice received.

When the auditor concludes that there is a material misstatement of fact in the other information which management refuses to correct, the auditor shall **notify those charged with governance or audit committee** of the auditor's concern regarding the other information and take any further appropriate action. In accordance with local practice this may include:

- (a) including a paragraph describing the material misstatement after the audit opinion
- (b) using the auditor's right under s. 141(7) of Companies Ordinance to be heard at the general meeting
- (c) withdrawing from the engagement.

7 Communicating with those charged with governance



Topic highlights

Auditors shall **communicate** specific matters to **those charged with governance** and HKSA 260 (Clarified) provides guidance to auditors in this area.

7.1 The importance of communicating with those charged with governance

HKSA
260.6, 11

HKSA 260 (Clarified) *Communication with those Charged with Governance* sets out guidance for auditors on the communication of audit matters arising from the audit of the financial statements of an entity with those charged with governance. However, auditors do not have to perform specific procedures to identify matters for the communication.



Key terms

'**Those charged with governance**' are the person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

Management are persons with executive responsibility for the conduct of the entity's operations.

The auditor must determine the appropriate person(s) within the entity's governance structure with whom to communicate. Communication with those charged with governance is important for the following reasons:

- (a) It assists the auditor and those charged with governance to **understand** audit-related matters in context and allows them to **develop a constructive working relationship**
- (b) It allows the auditor to **obtain information** relevant to the audit

HKSA 260.10

- (c) It assists those charged with governance to fulfil their **responsibility** to oversee the financial reporting process, thus reducing the risks of material misstatement in the financial statements

7.1.1 Communication with a subgroup of those charged with governance

When governance is a collective responsibility, a subgroup such as audit committee or an individual who may be charged with specific tasks to assist the governing body in meeting its responsibilities, the auditor shall determine whether the auditor also needs to communicate with the governing body.

7.1.2 Communication when all of those charged with governance are involved in managing the entity

In some smaller entities, all of those charged with governance are involved in managing the entity. Auditors do not need to communicate again with those same persons who are in both management and governance roles.

7.2 Matters to be communicated by auditors to those charged with governance

HKSA
260.16-17

The following matters shall be communicated to those charged with governance:

<p>The auditor's responsibilities in relation to the financial statements audit</p>	<p>Including that the auditor is responsible for forming and expressing an opinion on the financial statements and that the audit does not relieve management or those charged with governance of their responsibilities. This can be done by providing those charged with governance with a copy of the engagement letter.</p>
<p>Planned scope and timing of the audit</p>	<p>An overview of the planned scope and timing of the audit such as:</p> <ul style="list-style-type: none"> • How the auditor addresses the significant risks • The auditor's approach to internal control • The application of materiality in the audit • Other planning matters
<p>Significant findings from the audit</p>	<p>The auditor shall communicate the following:</p> <ul style="list-style-type: none"> • The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. • Significant difficulties encountered during the audit • Material deficiencies in the design, implementation or operating effectiveness of internal control that have come to the auditor's attention and have been communicated to management. • Significant matters arising from the audit that were discussed or subject to correspondence with management. • Written representations requested by the auditor. • Other matters that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

Auditor independence

The auditor shall communicate the following for **listed entities**:

- A statement that the engagement team and others in the firm, the firm, and network firms have complied with relevant ethical requirements regarding independence.
- All relationships between the firm and entity that may reasonably be thought to bear on independence.
- Related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

7.3 The communication process

HKSA 260.18

The auditor shall communicate with those charged with governance the **form, timing and expected general content** of communications. The auditor shall communicate with those charged with governance on a **timely basis** through structured presentations, written reports or discussions.

8 Evaluation of misstatements identified during the audit



Topic highlights

The auditor is required to evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements.



Key terms

HKSA 450.4

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.

Misstatements can arise from **error or fraud**.

Uncorrected misstatements are misstatements that the auditor has accumulated during the audit and that have not been corrected.

HKSA 450.3

Misstatements can arise due to the following situations:

- Inaccurate gathering or processing data from which the financial statements are prepared
- Omitting an amount or disclosure
- Overlooking an accounting estimate or misinterpreting a fact
- Judging wrongly an accounting estimate due to unreasonable selection and application of accounting policies

HKSA 450 (Clarified) *Evaluation of Misstatements Identified during the Audit* deals with the auditor's responsibility to **evaluate the effect of identified misstatements** on the audit and of uncorrected misstatements, if any, on the financial statements. The auditor's conclusion takes into account the auditor's evaluation of uncorrected misstatements and the materiality level before issuing the auditor's report.

The objective of the auditor in the evaluation is to evaluate:

- (a) the effect of identified misstatements on the audit
- (b) the effect of uncorrected misstatements, if any, on the financial statements.

8.1 Accumulation of identified misstatements

HKSA 450.5

HKSA 450 (Clarified) requires that the auditor **shall accumulate misstatements identified** during the audit other than those that are clearly trivial.

As a recap, the auditor may designate an amount below which misstatements would be clearly trivial and would not need to be accumulated as the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements.

Clearly trivial misstatements will have no impact on materiality and will be matters that are clearly inconsequential. Where there is any uncertainty about whether one or more items are clearly trivial, the matter is deemed to be not clearly trivial.

HKSA 450 (Clarified) requires the auditor shall accumulate misstatements other than those which are clearly trivial identified during the audit. It is necessary to distinguish misstatements as follows:

Factual misstatements	Judgment misstatements	Projected misstatements
Misstatements without doubt	Different with management's judgment on accounting estimates and auditors consider them as unreasonable Inappropriate accounting policies	Auditor's best estimate of misstatements in populations (Refer to audit sampling)

8.2 Consideration of identified misstatements as the audit progresses

HKSA 450.6

The auditor shall determine whether the **overall audit strategy and audit plan** need to be revised if there are identified misstatements or the other misstatements in aggregate are material.

If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall **perform additional audit procedures** to determine whether misstatements remain, the amount of the actual misstatement and whether adjustments shall be made.

8.3 Evaluating the effect of uncorrected misstatements

Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess **materiality determined** in accordance with HKSA 320 (Clarified) to confirm whether it remains appropriate in the context of the entity's actual financial results.

In making this determination, the auditor shall consider:

- the size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole
- the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions and accounts balances

The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. Auditors are advised to use the same evaluation approach for consistency.

8.3.1 Offsetting of misstatements

If an individual misstatement is considered to be material, it is unlikely that it can be offset by other misstatements. It may be appropriate to offset misstatements within the same account balance or class of transactions, only after considering the existence of further undetected misstatements.

8.3.2 Misstatements in classification

The auditor shall evaluate qualitative factors when determining whether a classification misstatement is material. The auditor may consider classification misstatement to be immaterial in the context of the financial statements as a whole.

8.4 Communication and correction of misstatements

HKSA 450.8

The auditor shall communicate on a **timely basis** all misstatements accumulated during the audit with the **appropriate level of management**, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements.

The auditor shall communicate with those charged with governance **uncorrected misstatements** and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation and the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. The auditor's communication shall identify material uncorrected misstatements individually.

8.4.1 Considerations Specific to Public Sector Entities

In the case of an audit of a public sector entity, the evaluation whether a misstatement is material may also be affected by the auditor's responsibilities established by law, regulation or other **authority** to report specific matters, including, for example, fraud.

Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with law, regulation or other authority.

8.5 Refusal to correct misstatements

HKSA 450.9

The auditor shall request management to correct those misstatements accumulated during the audit. If management **refuses** to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of **management's reasons** for not making the corrections and shall take that understanding into account when evaluating whether the **financial statements as a whole** are free from material misstatement.

8.6 Obtain written representations and documentation

HKSA
450.14-15

The auditor shall request a **written representation from management** and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

The auditor shall include in the audit documentation:

- The amount below which misstatements would be regarded as clearly unimportant
- All misstatements accumulated during the audit and whether they have been corrected
- The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion

9 Following up discovery of illegal acts or fraud



Topic highlights

In most instances the auditor will discuss findings with those charged with governance. The auditor may also consider the need to report to a proper authority in the public interest.

9.1 HKSA 240 (Clarified)

HKSA
240.40-43

Where the auditor becomes aware of a suspected or actual instance of fraud which could have a material effect on the financial statements, he shall:

- (a) consider whether the matter may be one that ought to be reported to a proper authority in the public interest; and where this is the case
- (b) except when he is prohibited by law from informing any party other than the proper authority or when the matter casts doubt on the integrity of those charged with governance, discuss the matter with those charged with governance, including any audit committee.

He should also notify in writing those charged with governance of his view.

In respect of an identified suspected or actual instance of fraud which could have a material effect on the financial statements, the auditor shall make a report direct to a proper authority in the public interest without delay and without informing those charged with governance in advance in situations where:

- (a) the auditor concludes that the matter ought to be reported to a proper authority in the public interest; and
- (b) the auditor is prohibited by law from informing any party other than the proper authority or the matter casts doubt on the integrity of those charged with governance.

An auditor who can demonstrate that he has acted reasonably and in good faith in informing an authority of an instance of fraud which he thinks has been committed would not be held by the court to be in breach of duty to the client even if, an investigation or prosecution having occurred, it was found that there has been no offence.

An auditor may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest.

The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

9.2 HKSA 250 (Clarified)

HKSA
250.22-28

The auditor shall obtain:

- (a) an understanding of the nature of the act and the circumstances in which it has occurred; and
- (b) further information to evaluate the possible effect on the financial statements.

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

The auditor may discuss the findings with those charged with governance where they may be able to provide additional audit evidence.

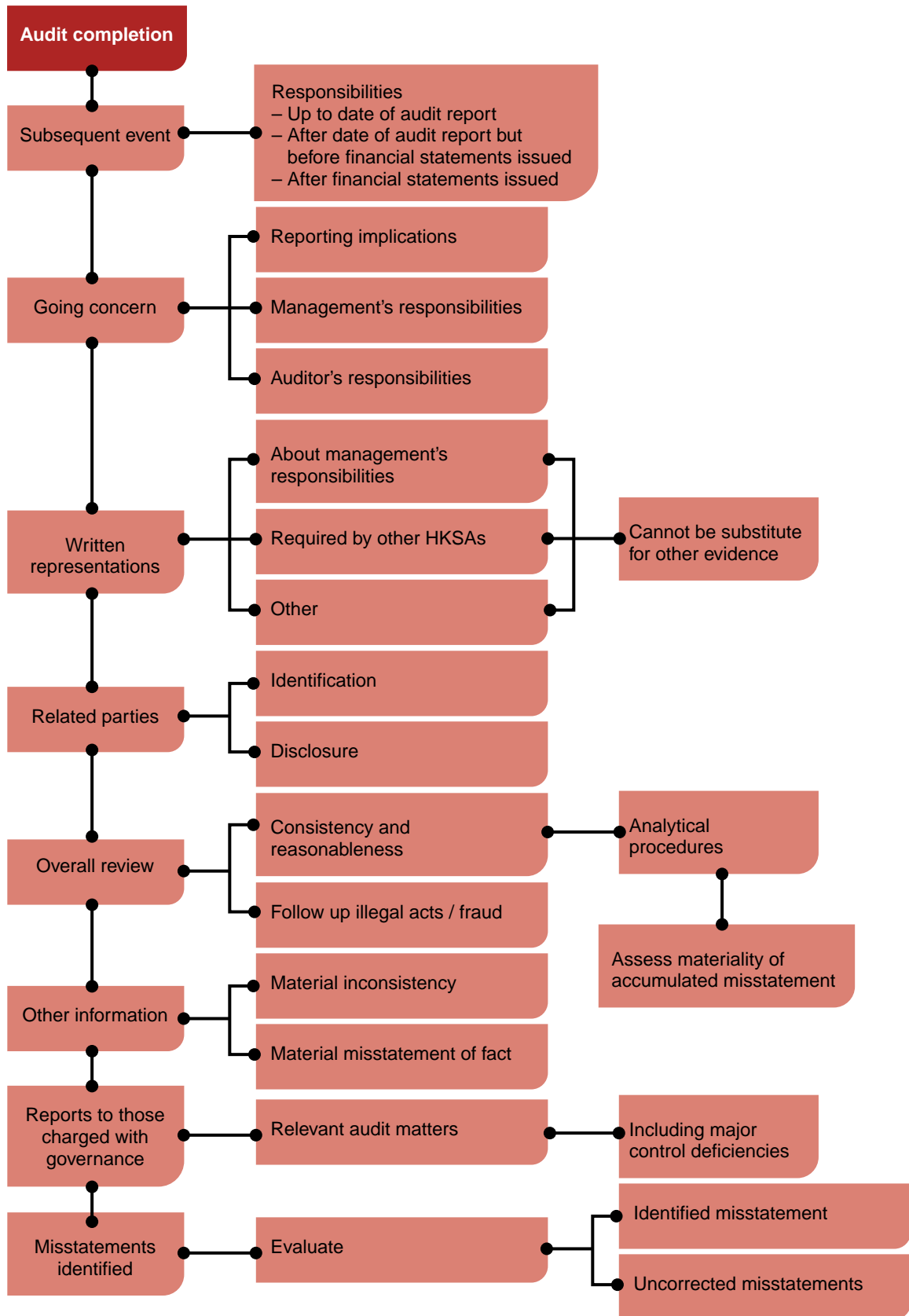
The auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations.

The auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations.

The auditor may consider withdrawal from the engagement, where withdrawal is possible under applicable law or regulation.

In some jurisdictions, the auditor of a financial institution has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities.

Topic recap



Answers to self-test questions

Answer 1

- (a) The settlement of HK\$8,000,000 was a subsequent event, and to be more specific, it was an event occurring between the date of financial statements and the date of the auditor's report.

In accordance with HKSA 560 (Clarified), the engagement team should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.

Such procedures ordinarily include the following:

- Reviewing procedures the management has established to ensure that subsequent events are identified.

For example, the engagement may consider whether the directors/management of SMC would be alerted of significant cash receipts subsequent to the financial year end.

If SMC has such procedures properly in place, it is likely that the management could identify the settlement on a timely basis.
- Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available.
- Given that such meetings would not be frequent, it is unlikely that these procedures would identify the settlement.
- Reading SMC's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.
- Given that the preparation of such statements and reports would not be frequent, it is unlikely that these procedures would identify the settlement.
- Inquiring, or extending previous oral or written inquiries, of SMC's lawyers concerning litigation and claims.

Unless the lawyers of SMC have been involved in dealing with the customer for settlement, such an inquiry or extended confirmation is unlikely to identify the settlement.
- Inquiring of management of SMC whether any subsequent events have occurred which might affect the financial statements.
- Provided that SMC has an effective and efficient internal system in identifying and reporting significant/major cash movements, it is very likely that the engagement team's inquiry of management would identify the settlement.

- (b) When the engagement team became aware of the settlement before the issue of the auditor's report, the engagement team should determine whether SMC's financial statements should be amended.

Given that the settlement of HK\$8,000,000 subsequent to the financial period provides evidence as to the recoverability of the receivable as at 31 December 20X9, the engagement team should normally request SMC to amend the financial statements such that the amount of impairment of receivables for the year ended 31 December 20X9 would be reduced by HK\$8,000,000.

If the management of SMC refuse to amend the financial statements, the engagement team should consider whether it is appropriate to issue a qualified opinion in accordance with HKSA 705 (Clarified).

Answer 2

- (a) EE Limited's auditor should consider the below in assessing the risk of material misstatement relating to EE Limited's financial statements as a whole in response to the rumour:
- Whether the valuation of the accounts receivable due from Y Limited will be impaired since Y Limited is reported to be in serious financial difficulty; and
 - Assess whether Y Limited is the single largest customer of EE Limited and whether the loss of business from Y Limited would seriously impact the going concern of EE Limited.
- (b) EE Limited's auditor should consider the audit procedures below in response to the rumour:
- Discuss the rumour with management and management's assessment of the rumour;
 - Perform independent checks on Y Limited's financial stability;
 - Review the year end outstanding accounts receivable balance due from Y Limited and assess any potential recoverability issues since Y Limited was reported to be in serious financial difficulty;
 - Understand and evaluate management's business and settlement plan with Y Limited, if any;
 - Review EE Limited's current financial position, budget and projected cash flow forecast and assess whether EE Limited is able to continue the operation as a going concern even if Y Limited is proven to be in financial difficulty; and
 - Reassess whether management has adopted an appropriate basis of preparation for the financial statements and consider whether sufficient financial statements disclosure has been made about going concern.

EE Limited's auditor should consider the below audit procedures on performing the subsequent event review:

- Ask the management whether there is any significant subsequent event to their knowledge that should be brought to the auditor's attention;
- Review management's procedures for identifying subsequent events to ensure that management are aware of the risks;
- Review meeting minutes and written resolutions of the board of directors and significant committees up to the date of the signed auditor's report;
- Review EE Limited's announcements and publications relating to EE Limited up to the date of the signed auditor's report;
- Review EE Limited's latest available management accounts, budget, cash flow forecast and management reports.

The above procedures collectively aim to investigate whether there have been any:

- New commitments, borrowings or guarantees;
- Sales or destruction of non-current assets;
- Changes of business structure;
- Issues of shares/debentures;

- Unusual accounting adjustments subsequent to year end;
- Litigation and claims to indicate potential contingent liabilities; and
- Significant changes in the assets and capital structure of EE Limited.

Answer 3

- (a) Common categories of matters included in the letter of representation:
- Confirmation of responsibility for, and approval of, the financial statements.
 - Confirmation that all of the accounting records, and all related documentation (such as minutes of management and shareholder meetings) have been made available, and that company transactions have been properly reflected therein.
 - Confirmation of the expected outcome of legal claims.
 - Confirmation of company plans in relation to certain tax provisions.
 - Confirmation of completeness of disclosures of related party transactions.
 - Confirmation that there have been no events after the balance sheet requiring revisions to the financial statements.
- (b) In order to emphasise its importance to management, and to explain that it forms a key part of audit evidence.

Answer 4

- (a) Factors that need to be considered to determine whether the purchases were made from a related party:
- Were the transactions entered into between the parties with normal terms of trade such as pricing and credit terms, compared to transactions made with other parties?
 - Were the transactions entered into between the parties without apparent business/commercial reasons?
 - Were the transactions made in a structure that places significant emphasis on legal form rather than actual substance?
 - Were the transactions carried out in a different manner compared to similar transactions made with other parties?
 - Was there an unexpectedly high volume or significant number of transactions made with the identified supplier?
 - Were the transactions handled by management/staff who normally are not responsible for this work?
- (b) If the purchases were made with a related party, I will do the following:
- Discuss the reasons for the purchases with directors and senior management of the company.
 - Send a positive confirmations request in connection with the terms of trade and amount of the purchases to the party concerned.
 - Discuss the issue directly with the party concerned and inspect documents in its possession.
 - Confirm the nature of the transactions or discuss the matter with other parties involved in/associated with the transactions.
 - Include specific representations covering the relationship between the company and the party, terms of trade and the amount in the letter of representation.