Qualification Programme

Module C: Business Assurance
Qualification Programme

Module C

Business Assurance
# Module C Business Assurance

## Part A Corporate governance
1. Scope of corporate governance
2. Corporate governance reports and practice

## Part B Internal assurance
3. Internal assurance

## Part C Professional standards and guidance
4. Code of Ethics
5. Framework for assurance engagements

## Part D Assurance engagements
6. Quality control
7. Changes in auditor appointment
8. Planning, materiality and risk assessment
9. Audit evidence, procedures, audit methodologies and audit sampling
10. Fraud and irregularities
11. Internal control and tests of controls
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Welcome to the Business Assurance module of the Qualification Programme of the Hong Kong Institute of Certified Public Accountants (the HKICPA).

You have made the decision to complete the HKICPA's qualification examination, Qualification Programme, a further step on your pathway to a successful business career as a CPA and a valued member of the HKICPA.

The Qualification Programme 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.

The Business Assurance module, like the other three modules, 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 Qualification Programme.

The four core modules of the Qualification Programme 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 Qualification Programme!

Jonathan Ng
Director of Student Education & Training
Hong Kong Institute of Certified Public Accountants
Introduction

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

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 (viii) 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.

Lastly but not least, you should note that the Learning Pack is not intended to be a ‘know-it-all’ resource. You are required to undertake background reading including standards, legislations and recommended texts for the preparation for workshop and examination.
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.
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**

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<thead>
<tr>
<th>Competency</th>
<th>Chapter where covered</th>
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<td>LO1. Professional standards and guidance:</td>
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<td>Identify and where appropriate apply ethical standards, legislation and professional guidance:</td>
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<td>LO1.01 The Institute’s Code of Ethics for Professional Accountants:</td>
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<td>1.01.02 Identify, evaluate and respond to threats to compliance with the fundamental principles</td>
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<td>1.01.03 Discuss and evaluate the effectiveness of available safeguards</td>
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<td>1.01.04 Recognise and advise on conflicts in the application of fundamental principles for Professional Accountants in practice and in business</td>
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<td>LO1.02 Professional standards and guidance:</td>
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<td>LO1.03 Legal and regulatory framework governing the profession:</td>
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<td>1.03.01 Explain the regulatory framework for assurance and non-assurance engagements in Hong Kong</td>
<td>5</td>
</tr>
<tr>
<td>1.03.02 Explain the nature and purpose of assurance and non-assurance engagements</td>
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</table>
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:

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<td>Identify the issues relating to other assurance and non-assurable engagements, including:</td>
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<td>Investment circular reporting engagements</td>
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<td>Preliminary announcements of annual results</td>
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<td>2.02.01.06</td>
<td>Comfort letters</td>
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<td>2.02.01.07</td>
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<td>LO2.03</td>
<td>Client and engagement acceptance procedures:</td>
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<tr>
<td>2.03.01</td>
<td>Explain the reasons why entities change their auditors/professional accountants</td>
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<td>2.03.02</td>
<td>Explain the requirements relating to the appointment of auditors under the Hong Kong Companies Ordinance</td>
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<td>Explain the procedure for a change of auditors</td>
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<td>Explain the rights of the auditors in the process of a change of auditors</td>
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<td>2.03.05</td>
<td>Explain the professional clearance procedures</td>
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<tr>
<td>2.03.06</td>
<td>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:</td>
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<td>2.03.06.01</td>
<td>Client acceptance</td>
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</tr>
<tr>
<td>2.03.06.02</td>
<td>Engagement acceptance</td>
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<tr>
<td>2.03.06.03</td>
<td>Agreement of the terms of engagement</td>
<td>7</td>
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<tr>
<td>2.03.07</td>
<td>Identify the issues relating to the agreement of the scope and terms of an engagement with a client</td>
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<td>LO2.04</td>
<td>Audit methodologies:</td>
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<td>2.04.01</td>
<td>Describe the key features of the following audit methodologies:</td>
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<td>Balance sheet approach</td>
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<td>Directional testing</td>
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<td>Identify and explain:</td>
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<td>2.05.01.01</td>
<td>The need for planning an audit</td>
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<td>2.05.01.02</td>
<td>The contents of the overall audit strategy and the audit plan</td>
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<tr>
<td>2.05.01.03</td>
<td>The relationship between the overall audit strategy and the audit plan</td>
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<th>2.05.02</th>
<th>Develop and document an audit plan</th>
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<tr>
<td>2.05.03</td>
<td>Explain how auditors obtain an initial understanding of the entity and its environment including the use of preliminary analytical review procedures</td>
</tr>
<tr>
<td>2.05.04</td>
<td>Explain the components of audit risk</td>
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<td>2.05.05</td>
<td>Assess the risk of material misstatement at the financial statement level and assertion level</td>
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<td>2.05.06</td>
<td>Recognise and suggest overall responses to assessed risk</td>
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<td>2.05.07</td>
<td>Recognise and suggest specific procedures to respond to assessed risks</td>
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<td>2.05.08</td>
<td>Explain the effect of fraud and misstatements on audit planning and work</td>
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<td>2.05.09</td>
<td>Explain the effect of law and regulations, and non-compliance therewith, on audit planning and procedures</td>
</tr>
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<td>LO2.06</td>
<td>Quality control considerations:</td>
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<tr>
<td>2.06.01</td>
<td>Explain the principles and purposes of quality control of audit and other assurance engagements</td>
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<td>2.06.02</td>
<td>Identify the features of a system of quality control relevant to a specific firm</td>
</tr>
<tr>
<td>2.06.03</td>
<td>Choose and explain quality control procedures that are relevant to a specific audit engagement</td>
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<td>2.06.04</td>
<td>Assess and explain whether an engagement has been performed in line with professional standards and whether reports issued are appropriate</td>
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<tr>
<th>LO2.07</th>
<th>Documentation:</th>
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<td>Document an audit plan</td>
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<td>2.07.02</td>
<td>Explain the need for and the importance of audit documentation</td>
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<tr>
<th>LO2.08</th>
<th>Materiality:</th>
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<tr>
<td>2.08.01</td>
<td>Define materiality and demonstrate how it should be applied in the context of financial reporting and auditing</td>
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<tr>
<th>LO2.09</th>
<th>Audit procedures:</th>
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<td>2.09.02</td>
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<td>2.09.03</td>
<td>Apply the basic principles of sampling</td>
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<td>Assess and explain the results of sampling</td>
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<td>Explain the importance of internal control to auditors</td>
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<td>2.09.06</td>
<td>Explain how auditors identify weaknesses in internal control systems and how those weaknesses limit the extent of auditors’ reliance on those systems</td>
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<td>2.09.07</td>
<td>Explain the types of substantive procedures</td>
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<td>2.09.08</td>
<td>Explain what is meant by analytical review and how analytical review procedures are used in an audit</td>
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<td>2.09.09</td>
<td>Explain the appropriate audit tests for:</td>
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2.09.10 Discuss the audit problems and identify procedures for the audit of:

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<th>Chapter where covered</th>
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<td>Opening balances 15</td>
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<td>2.09.10.05</td>
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2.09.11 Recognise and explain the issues relating to the audit of a group of companies 18

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**LO2.10 Audit evidence:**

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<th>Chapter where covered</th>
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<tr>
<td>2.10.02</td>
<td>Assess the appropriateness and sufficiency (relevance and reliability) of different sources of audit evidence 3 9</td>
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<tr>
<td>2.10.03</td>
<td>Explain the assertions contained in the financial statements and their use in obtaining evidence 3 9</td>
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<tr>
<td>2.10.04</td>
<td>Explain the need to modify the audit strategy and audit plan following the results of tests of control 3 11</td>
</tr>
<tr>
<td>2.10.05</td>
<td>Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations 2 14</td>
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**LO2.11 Internal audit:**

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<tr>
<td>2.11.02</td>
<td>Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations 3, 14</td>
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### LO2.12 Completion procedures:

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<th>Explain the purpose of and procedures to be used in:</th>
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<td>Obtaining written representations from management</td>
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<td>2.12.01.04</td>
<td>Review of report by other auditors to principal auditors of a group of companies</td>
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<tr>
<td>2.12.01.05</td>
<td>Overall review of the financial statements</td>
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<tr>
<td>2.12.01.06</td>
<td>Review of other published information</td>
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</table>

| 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 act or fraud found while performing an audit |

### LO2.13 Reporting:

| 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 |
| 2.13.02 | Explain the requirement for an auditor to report to management or those charged with governance |
| 2.13.03 | Explain and analyse the format and content of unmodified audit reports |
| 2.13.04 | Explain and analyse the format and content of modified audit reports |

### 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:**

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<tr>
<th>LO3.01</th>
<th>Background to corporate governance developments:</th>
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<tr>
<td>3.01.01</td>
<td>Explain the objectives, concepts, relevance and importance of corporate governance</td>
</tr>
<tr>
<td>3.01.02</td>
<td>Discuss the provisions of international codes of corporate governance (such as OECD) that are most relevant to auditors</td>
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<tr>
<td>Competency</td>
<td>Chapter where covered</td>
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**LO4. Computerised business systems**

**Discuss the features of computerised business systems and assess and advise on risk and control frameworks:**

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<td>Impact of increasing use and share of ownership by accountants in corporate information system</td>
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# List of Auditing Standards

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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
2 Corporate governance and agency
3 Stakeholders in corporate governance
4 Major issues in corporate governance
5 Corporate social responsibility

Learning focus

Assurance and audit-related services are important areas for auditors in practice.

In recent years, management of companies have been asked to provide more information. As a result, auditors have been asked to report on this information, so giving rise to the need for assurance services.
In this chapter you will cover the following learning outcomes:

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<td>Explain the objectives, concepts, relevance and importance of corporate governance</td>
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<td>Discuss the provisions of international codes of corporate governance (such as the OECD) that are most relevant to auditors</td>
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<td>Explain the concept of stakeholder theory in corporate governance</td>
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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 being 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, i.e., 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. But in companies where the shareholders are not employed to manage the business, 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. This arises when shareholders, who are actually the owners (the principals), delegate decision-making authority for the day-to-day running of a company 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. This is known as the agency problem, which we shall examine further later on.

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 the 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’s Combined Code of July 2003, with additional rules on connected transactions and minority 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 in every entity for processes to be in place to ensure that the interests of every stakeholder in the company 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 dangers 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, the Code on Corporate Governance Practices sets out the principles of good corporate governance. 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. 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.
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.
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 information 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 HK 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 responsively 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 organization (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 completeness. 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:

<table>
<thead>
<tr>
<th>Statement on corporate governance</th>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Directors remuneration</td>
<td>In order to enhance comparability and transparency of director's 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.</td>
</tr>
<tr>
<td>Disclosure of standard remuneration and directors' share options</td>
<td>Directors' standard remuneration should be analysed and details of directors' share options should be disclosed such as value of the share options.</td>
</tr>
<tr>
<td>Non-audit fees paid to the auditors</td>
<td>Disclosure of any non-audit fees should be disclosed as this would affect auditor's independence.</td>
</tr>
</tbody>
</table>

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 practices 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.

<table>
<thead>
<tr>
<th>Standards of behaviour</th>
<th>Ethical Conduct – governing board members should endeavor to exemplify the personal qualities in their entirety 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</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organisational structures and processes</td>
<td>(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</td>
</tr>
</tbody>
</table>
| Risk management and control                  | (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  | (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. |

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 organizations 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 forms part of the UK Combined Code on Corporate Governance.

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:

| **Value-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** | 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. 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. |
| **Personnel** | A multi-disciplinary and cross-functional group including international personnel should lead code development where organisational size permits. 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. |
| **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** | 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 program should sustain interest in and commitment to the code. Employees and others should be made aware of the consequences of not adhering to the code. |
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 fulfill their responsibilities as agents by requiring disclosure and suggesting they be 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
(4) Duty to act in good faith in the interests of the company

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 HK 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

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 in joint stock companies derives from the principals (owners) not being able to run the business themselves and therefore having to rely on agents (directors) to do so for them. This **separation of ownership from management** can cause a conflict of interest 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 or because they have **different attitudes to risk-taking** to the shareholders.

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 maximizing 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 organization 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:

(a) profit-related/economic value-added pay  
(b) rewarding managers with shares  
(c) 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

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:

<table>
<thead>
<tr>
<th>Stakeholder group</th>
<th>Members</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal stakeholders</td>
<td>Employees, management</td>
</tr>
<tr>
<td>Connected stakeholders</td>
<td>Shareholders, customers, suppliers, bankers, lenders, trade unions, competitors</td>
</tr>
<tr>
<td>External stakeholders</td>
<td>The government, local government, the public, pressure groups, opinion leaders</td>
</tr>
</tbody>
</table>

There are other ways of classifying stakeholders.
3.4 **Reconciling viewpoints of different stakeholders**

*Enlightened long-term value maximization* offers the best, fairest, method of reconciling the competing interests of stakeholders. Enlightened long-term value maximization means pursuing profit maximization, but with regard to *business ethics* and the *social consequences of the organization'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 maximize 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 (HK) 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 HK are controlled by family members.
Apart from this, there are some restrictions regarding the composition of the Board in HK. Under Listing Rule requirements (Ch. 3, Sec 3.21) an audit committee is mandatory in a board of directors, chaired by an independent non-executive director (INED). The audit committee must comprise at least three members, with the majority being INEDs. As for the whole board, there must comprise at least three INEDs. Regarding duties and responsibilities of the Board of directors and the code of best practices on corporate governance, various organisations in Hong Kong had published non-statutory guidelines on these, including the Hong Kong Institute of Directors (HKIoD), the Hong Kong Institute of Certified Public Accountants (HKICPA) as well as the Hong Kong Exchange and Clearance Ltd (HKEx).

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 and also in terms of age (to ensure senior directors are bringing on newer ones to help succession planning).

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.

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 **organization 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 organization, 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 organizations) may be complicated by their being **accountable in turn to the wider public**.

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**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.

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**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.

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**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**.

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**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.

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**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.

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**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)
Corporate governance is defined by the UK Cadbury Committee Report (1992) as the 'system by which a company is being 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).

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.

Corporate governance 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. Corporate governance frameworks aim to ensure directors/managers fulfil their responsibilities as agents by requiring disclosure and suggesting they be rewarded on the basis of performance.

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.

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.

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.
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 cooperation 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:

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

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.
Corporate governance

Briefly explain what is meant by corporate governance and discuss how the main measures recommended by the corporate governance codes should contribute towards better corporate governance.

(15 marks)
chapter 2
Corporate governance reports and practice

Topic list
1 Significance of international codes
2 Code on Corporate Governance Practices in Hong Kong and the UK Corporate Governance Code
3 Corporate governance developments in Hong Kong
4 Board committees
5 Management's responsibilities to comply with corporate governance requirements

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 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’s 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.
In this chapter you will cover the following learning outcomes:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>Learning outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td><strong>3.01</strong> Background to corporate governance developments</td>
</tr>
<tr>
<td></td>
<td>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</td>
</tr>
<tr>
<td>2</td>
<td><strong>3.02</strong> Key issues relating to corporate governance including directors’ remunerations, board composition, audit committee and non-controlling interest</td>
</tr>
<tr>
<td></td>
<td>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</td>
</tr>
<tr>
<td>3</td>
<td><strong>3.03</strong> Management’s responsibilities to comply with corporate governance requirements and to implement related practices</td>
</tr>
<tr>
<td></td>
<td>3.03.01 Explain the responsibilities of management within the corporate governance framework</td>
</tr>
<tr>
<td></td>
<td>3.03.02 Analyse the structure and roles of board committees and discuss their drawbacks and limitations</td>
</tr>
<tr>
<td>3</td>
<td><strong>3.04</strong> Auditor’s responsibilities to consider and address corporate governance requirements</td>
</tr>
<tr>
<td></td>
<td>3.04.01 Explain the auditor’s responsibility to consider and address corporate governance requirements</td>
</tr>
</tbody>
</table>
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 companies. 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 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, who 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 (HKSE) published the Code on Corporate Governance Practices (the HK Code) and the Corporate Governance Report (CGR) in November 2004, which was 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. 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 five main areas which will be examined later in this chapter:

1. Directors
2. Remuneration of Directors
3. Accountability and Audit
4. Delegation by the Board
5. Communication with Shareholders

The UK Corporate Governance 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 report in the UK was the first code of corporate governance produced. 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. In 1999, Turnbull produced a report relating to risk management and internal control for listed companies.

In 2002, the Higgs report (Review of the role and effectiveness of non-executive directors) was commissioned to produce a single comprehensive code, which was refined to produce the UK Corporate Governance Code. At the same time, the Smith report was produced on the role of audit committees, and the recommendations of this were incorporated into the new Corporate Governance Code.

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, and communication with shareholders.

The HK Code contains a combination of broad principles and more specific provisions. It uses a 'comply or explain' approach. Under the Listings Rules, listed companies in HK have to disclose whether they have applied the principles, if they have not, to provide an explanation as to why.

The HK code was first issued in November 2004 and became effective in 2005. The major principles of the HK Code are as follows.
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.

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.

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 board should be balanced between 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.

Notes
1  Under rule 3.10, every board of directors of a listed issuer must include at least three independent non-executive directors.
2  Guidelines on independence of independent non-executive directors are set out in rule 3.13.

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.

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.

Note: These duties are summarised in "Non-statutory Guidelines of Directors' Duties" issued by the Companies Registry in January 2004. In determining whether a director has met the requisite standard of care, skill and diligence expected of him, courts will generally have regard to a number of factors. These include the functions that are to be performed by the director concerned, whether the director is a full-time executive director or a part-time non-executive director and the professional skills and knowledge of the director concerned.

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.
Section B: Remuneration of directors and senior management

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 24B of Appendix 16, 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.

2. 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.

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.

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 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.

Voting by Poll

The issuer should ensure that shareholders are familiar with the detailed procedures for conducting a poll.
By comparison, the **UK Corporate Governance Code** (formerly the Combined 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 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 Code contains broad principles and more specific provisions. 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.

In May 2010 the FRC issued a new edition of the Code which will apply to financial years beginning on or after 29 June 2010. Compared with the HK Code, the UK Corporate Governance Code is substantially more detailed.

### 2.1.3 Auditors and the Code

Both the HK and the UK Corporate Governance Code makes reference to the importance of an audit in the following ways.

(a) It is strongly recommended that all entities have an **independent annual audit** of their financial statements.

(b) The importance of the qualities of **reliability** and **comparability** in financial reporting is stressed. This allows investors to make better investment decisions. It requires appropriate levels of disclosures and a high quality auditing standards.

Auditors may be asked to check whether a listed company follows the provisions in the Corporate Governance Code for the following:

- **Directors’ responsibility** for preparing financial statements explained in the directors’ report
- **System of internal control reviewed** and reported on. (This should cover all significant controls, including financial, operational and compliance controls and risk management systems.)
- An audit committee of **at least three non-executive directors** should be set up. The board should satisfy itself that at least one member of the audit committee must be an independent non-executive director who has appropriate professional qualifications, or accounting or related financial management expertise.
- The audit committee terms of reference should be set out in writing and publicly available or described in a report.
- The audit committee should enable whistle-blowers who wish to report a suspicion or evidence of fraud or impropriety an appropriate channel to express their concerns to encourage them to come forward.
- The audit committee monitors and reviews the effectiveness of internal control.
- The audit committee has primary responsibility for the appointment of external auditors.
- Where an external audit firm also provides non-audit services (covered later in this Learning Pack), the annual report should set out how independence maintained to ensure the firm has taken appropriate safeguards against the self-review and self-interest threats eg ensuring no over reliance on single entity).

The entity must also provide a statement showing how it has applied the principles relating to directors’ remuneration.

**The auditor’s consideration of corporate governance**

The auditor will consider the client’s corporate governance arrangements at several different stages of the audit.
HKSA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment requires the auditor to obtain an understanding of the client’s operations and governance structures, to enable him to understand the transactions, balances and disclosures that would be expected in the financial statements. The auditor is also required to obtain an understanding of the internal controls relevant to the audit. One key component of an effective internal control system is a strong control environment which can best be achieved by following best practices of corporate governance. Thus the auditor’s judgement of the strength of the client’s corporate governance arrangements will feed in to the auditor’s decisions on the appropriate audit approach and strategy to be followed.

HKSA 330 The Auditor’s Responses to Assessed Risks explains how the auditor should respond to the risks of material misstatement which he identified while complying with HKSA 315, including how he should respond to the corporate governance arrangements identified and assessed. For example, if the control environment is found to be poor, then there is an increased risk of material misstatement at the financial statement level and the auditor may wish to:

- conduct more audit procedures at the period end rather than during an interim audit, and/or
- increase the amount of substantive procedures undertaken, and/or
- increase the number of locations included in the audit scope.

The auditor will wish to communicate his adverse assessment of the client’s corporate governance arrangements when he writes to the entity following the audit in accordance with HKSA 260 Communication with Those Charged with Governance.

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. One way of managing risk that is stipulated in the HK Code requires that there is clear division of responsibility at the head of a company between the chairman and the chief executive. This means that no one individual has unfettered powers of decision (Appendix 14, Section A.2).

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 director's 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 (Appendix 14, Section C.2.6).

Directors are also responsible for monitoring the effectiveness of systems and controls. 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 internal control made the following recommendations:

<table>
<thead>
<tr>
<th>Turnbull Guidelines</th>
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<tbody>
<tr>
<td>Have a defined process for the effectiveness of internal control</td>
</tr>
<tr>
<td>Review regular reports on internal control</td>
</tr>
<tr>
<td>Consider key risks and how they have been managed</td>
</tr>
<tr>
<td>Check the adequacy of action taken to remedy weaknesses and incidents</td>
</tr>
<tr>
<td>Consider the adequacy of monitoring</td>
</tr>
<tr>
<td>Conduct an annual assessment of risks and the effectiveness of internal control; and</td>
</tr>
<tr>
<td>Make a statement on this process in the annual report</td>
</tr>
</tbody>
</table>

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.

Board composition has a significant impact on corporate performance. From the key term above the importance of non-executive directors is their detachment from the day to day operational responsibility of the company, in other words they are 'objective'. The HK Code requires the composition of the board to be 'a balanced composition of executive and non-executive directors (including independent non-executive director)'.

Under Listing Rule 3.10 in Hong Kong, every board of directors of a listed issuer must include at least three 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
The Stock Exchange of Hong Kong Ltd (HKSE) (which we shall now refer to as the Hong Kong Stock Exchange or the Exchange for the sake of consistency) published the Code on Corporate Governance Practices (the HK Code) and the Corporate Governance Report (CGR) in November 2004, which was 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. 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 development of Corporate Governance in Hong Kong is considered as 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 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 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.)
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 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 Exchange Listing Rules. In addition, the Exchange requires Main Board and GEM listed companies to include a CGR in both annual and half-yearly returns. The Exchange sets out mandatory and recommended disclosures (discussed in Section 3.6) for inclusion in the CGR, which is a new report that boards must prepare and include in the annual report. Failure to include any of the mandatory disclosures in the CGR will be regarded by the 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 HK 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:

(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 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 have attributed the current global economic downturn to a failure of those in corporate governance, such as non-executive directors and audit committees, to manage risk effectively. Others 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. However, in Hong Kong, since the issuance of the Code by the HK Stock Exchange in 2004, there has been no further review.

In May 2010 the UK Financial Reporting Council (FRC) issued a new edition of the UK Corporate Governance Code which will apply to financial years beginning on or after 29 June 2010. This followed a review of the Code carried out during 2009 and consultation on a draft of the revised Code that ended in March 2010.

3.5 Structure of the Code in Hong Kong

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, but may choose to deviate from, the code provisions. 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
C Accountability and audit
D Delegation by the board and
E Communication with shareholders

<table>
<thead>
<tr>
<th>Key provisions of the HK Code</th>
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<tbody>
<tr>
<td><strong>A Directors</strong></td>
</tr>
<tr>
<td>• Every company should be headed by an effective board, which is responsible for leadership and control and for promoting the success of the company.</td>
</tr>
<tr>
<td>• The board should meet regularly where appropriate agenda, meeting notices and meeting minutes are prepared.</td>
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<tr>
<td>• The roles of chairman and chief executive officer should be separated and should not be performed by the same individual.</td>
</tr>
<tr>
<td>• The board should include a balanced compositions of executive and non-executive directors (and in particular independent non-executive directors) so that there is a strong independent element on the board.</td>
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</table>
### Key provisions of the HK Code

- 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.

- 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.

### B Remuneration of directors and senior management

- 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, not a provision as such**).

### C Accountability, financial reporting and audit

- The board should present a balanced, clear and comprehensive assessment of the company’s position, performance and prospects. Management should provide explanations and information to the board for such assessment.

- 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 system of internal control of the company.

- The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.
Key provisions of the HK Code

- 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 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 the Report.
- The annual review should consider the adequacy of resources, qualifications and experience of staff of the listed company's accounting and financial reporting function, and their training programs and budget.

D Delegation by the board

- The company should have a formal schedule of matters specifically reserved to the board for its decision.
- The board should give clear directions as to the powers of management for delegating aspects of management and administration functions.
- The board committees should be formed with specific written terms of reference and deal clearly with the committees' authority and duties.
- Board committees should report back to the board on their decisions or recommendations.

E Communications with shareholders

- 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 company should regularly inform shareholders of the procedures for voting by poll and ensure compliance with the voting by poll requirements. The chairman of the meeting should at the commencement of the meeting ensure that an explanation is provided of the detailed procedures for conducting a poll and then answer any questions from shareholders regarding voting by way of a poll.

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 Exchange as a breach of the Listing Rules.
- **Recommended disclosure requirements**: The 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 requirement
--- | ---
• Corporate governance practices | • Shareholders’ rights
• Board details | • Share interests of senior management
• Directors’ securities transactions | • Investor relations
• Non-executive directors’ terms of appointment | • Division of responsibility between the board and management
• Identity and segregation of chairman and chief executive officer | • Additional disclosures regarding internal control
• Directors’ remuneration policy and nomination | |
• Auditors’ remuneration | |
• Audit committee | |

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 listed company has complied the principles in the HK Code for any inconsistencies with the audited financial statements.

## 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.

However, good use of committees seems to have had a positive effect on the governance of many companies. It is found evidence 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 **independent non-executive directors**. 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 primary 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

The exact role of an audit committee will vary from entity to an entity. An audit committee is a sub-committee of the board of directors. Audit committees must be composed of only non-executive directors, and must have at least three members. At least one of the members must be an independent non-executive director who has appropriate professional qualifications or accounting or related financial management expertise. The majority of its members must be independent non-executive directors, and the chairman of the audit committee must be an independent non-executive director as well. 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 judgement into the entity's affairs
(d) To help the finance financial offer, 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

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:
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.
Code provisions relating to the audit committee in Hong Kong

(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).

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 audit 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) To meet at least once a year with the external auditors to review the financial information.

(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.

Some of the other suggestions for audit committees responsibilities are that they:

- meet with the external auditors, at least annually, in the absence of management, to discuss matters relating to their audit fees, any issues arising from the audit and any other matters the auditors may wish to raise, and
- consider establishing policies with respect to hiring employees or former employees of the external auditors.

4.1.2 Drawbacks of audit committees

We discussed the possible benefits of the audit committee above.

Opponents of audit committees argue that:

(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 committees

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

### 4.3 Remuneration committees

#### 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. Section B of Appendix 14 of the Main Board Listing Rules covers the recommendations relating to the Remuneration of Directors and Senior Management. In Section B 1.1 it specifically states that:

‘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 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.

The remuneration committee should make recommendations to the board on the policy and structure for remuneration, and have the delegated authority to determine the specific remuneration package of all executive directors and senior management. The committee also needs to review and approve performance-based remuneration and compensation arrangements relating to dismissal or removal of directors, and loss of their office or appointment.

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

(a) Summarise the principles in the HK Corporate Governance Code relating to remuneration of directors.

(b) Describe the main areas of concern that should be addressed by a remuneration committee.

(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, 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.
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.

The **HK Code** and **Corporate Governance Report** (CGR) became effective in 2005. 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 **five** main areas:

1. Directors
2. Remuneration of Directors
3. Accountability & Audit
4. Delegation by the Board
5. Communication with Shareholders

The **UK Corporate Governance 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.

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.

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.

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

- 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.
Care Co

Care Co is a registered charity with 100 employees and 250 volunteers providing in-home care for elderly persons who are unable to fully take care of themselves. The company structure has no shareholders in a practical sense although a small number of issued shares are held by the sponsors who established the charity many years previously. Care Co is governed by a seven-member Board of Directors. The Chief Executive Officer (CEO) chairs the Board which comprises the Chief Financial Officer (CFO) and five independent, unpaid non-executive directors who were appointed by the CEO based on past business relationships. You are one of the independent members of Care Co’s Board.

The CEO/Chair sets the Board agendas, distributes Board papers in advance of meetings and briefs Board members in relation to each agenda item. At each of its quarterly meetings the Board reviews the financial reports of the charity in some detail and the CFO answers questions. Other issues that regularly appear as agenda items include new government funding initiatives for the client group, and the results of proposals that have been submitted to funding agencies, of which about 25% are successful. There is rarely any discussion of operational matters relating to the charity as the CEO believes these are outside the directors’ experience and the executive management team is more than capable of managing the delivery of the in-home care services.

The Board has no separate audit committee but relies on the annual management letter from the external auditors to provide assurance that financial controls are operating effectively. The external auditors were appointed by the CEO many years previously.

Care Co’s Board believes that the company’s corporate governance could be improved by following the principles applicable to listed companies.

Required

Recommend how Care Co’s board should be restructured to comply with the principles of good corporate governance.

(20 marks)
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.
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:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>Learning outcome</th>
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<tr>
<td>2.09</td>
<td><strong>Audit procedures</strong></td>
</tr>
<tr>
<td>2.09.05</td>
<td>Explain the importance of internal control to auditors</td>
</tr>
<tr>
<td>2.11</td>
<td><strong>Internal audit</strong></td>
</tr>
<tr>
<td>2.11.01</td>
<td>Explain the relationship between internal auditors and external auditors</td>
</tr>
<tr>
<td>3.05</td>
<td><strong>Implications of overseas legislation such as the Sarbanes-Oxley Act 2002 on Hong Kong companies and auditors</strong></td>
</tr>
<tr>
<td>3.05.01</td>
<td>Explain the effect of the Sarbanes-Oxley Act 2002 on Hong Kong companies and their auditors</td>
</tr>
</tbody>
</table>
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

As stated earlier, the ultimate responsibility for a company's system of internal controls lies with the board of directors. The board should set procedures of internal control and regularly monitor that the system operates effectively. The board may do this through an internal audit department, which sends a strong message about the board's commitment to its governance responsibilities.

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.

Section C of Appendix 14 of the Main Board Listing Rules states the provisions relating to Accountability and Audit. Section C.2 covers Internal Controls. The key principle in these provisions 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.'

In order to ensure that sound and effective internal controls are maintained, Section C 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. In particular, the review should, consider the adequacy of resources, the qualifications and experience of the staff of the accounting and financial reporting function, and their training programmes and budget.

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.

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.

Section C.2.4 recommends that Issuers should disclose as part of the Corporate Governance Report a narrative statement detailing how they have complied with the code provisions on internal control during the reporting period.

By comparison the UK Corporate Governance Code recommends that the board of directors reports on its review of internal controls as part of the directors’ report which forms part of the annual report.
Business Assurance

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 assessment should cover the following.

(a) Any changes since the last assessment in risks faced, and the company's capability to respond to challenges in its business environment
(b) The scope and quality of management's monitoring of risk and internal control, the work of internal audit, if it exists, reasons for against an internal audit function if the company does not have one
(c) The extent and frequency of reporting to the board
(d) Significant control deficiencies which either have or might have material impacts upon the financial statements
(e) The effectiveness of the public reporting processes

1.3 Auditors' responsibilities for internal control

The Code on Corporate Governance Practices (Appendix 14) does not mention specifically that the auditors have a responsibility for internal control. However, the UK Corporate Governance Code considers what auditors should do in response to a statement on internal controls by directors.

The UK Corporate Governance Code states that 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 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.

To avoid misunderstanding on the scope of the auditors' role, the UK Corporate Governance Code emphasises that 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.
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 businesses 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) 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 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 it is recommended that:

- Where there is no internal audit function, to consider annually whether there is a need for this function and make a recommendation to the board; and
- Where there is no internal audit function, to explain in the annual report the absence of such a function.

**Role of internal audit in corporate governance**

Internal audits are placed perfectly to assist management in the assessment of risks and internal controls required by the Hampel and Turnbull reports in the UK. The Turnbull report in particular highlights the role internal audit can have in providing objective assurance and advice on risk and control.

The Turnbull report sets out some key guidelines for the board.

**TURNBULL GUIDELINES**

- 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 Turnbull 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

Turnbull requires 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 organization. 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 appropriate is given to them in HKSA 610 (Clarified) Using the Work of Internal Auditors.

The HKSA states that the external auditors must give consideration first to the scope and organisation of the internal audit department and then evaluate the specific audit work they are interested in.

The following factors must be considered:

- Proficiency and training of the people who have undertaken the work
- Level of supervision, review and documentation of the work of assistants
- Sufficiency and appropriateness of evidence to draw conclusions
• Appropriateness of conclusions drawn
• Consistency of any reports prepared with the work performed
• Whether the work necessitates amendment to the external audit programme

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.

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 issue of the Turnbull guidance and internal audit’s role in relation to risk management was touched on. In response to the Turnbull guidance, 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 on 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(3,4),(996,993) 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 audit 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:

<table>
<thead>
<tr>
<th>Advantages of outsourcing</th>
<th>Disadvantages of outsourcing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Staff do not need to be recruited, as the <strong>service provider has good quality staff</strong>.</td>
<td>• There will be <strong>independence</strong> and <strong>objectivity</strong> issues if the company uses the same firm to provide both internal and external audit services.</td>
</tr>
<tr>
<td>• The service provider has different <strong>specialist skills</strong> and can assess what management require them to do.</td>
<td>• The <strong>cost</strong> of outsourcing the internal audit function might be high enough to make the directors choose not to have an internal audit function at all.</td>
</tr>
<tr>
<td>• Outsourcing can provide an <strong>immediate</strong> internal audit department.</td>
<td>• Company staff may oppose outsourcing if it results in <strong>redundancies</strong>.</td>
</tr>
<tr>
<td>• <strong>Associated costs</strong>, such as staff training, are <strong>eliminated</strong>.</td>
<td></td>
</tr>
</tbody>
</table>
Advantages of outsourcing | Disadvantages of outsourcing

- 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’.
- 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:

(a) Setting performance measures in terms of cost and areas of the business reviewed and investigating any variances
(b) Ensuring appropriate audit methodology (working papers/reviews) is maintained
(c) Reviewing working papers on a sample basis to ensure they meet internal standards/guidelines
(d) Agreeing internal audit work plans in advance of work being performed
(e) 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 Body (‘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 had been the most important piece of legislation which seriously affects the corporate governance, financial disclosures and total accounting pattern in the 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 stated in the Sarbanes Oxley act is the ones that has caused the most concern in the financial sector according to which requires the corporate body to enhance stricter controls over the financial reporting by internal accounting personnel.

3.2.2 Application of Sarbanes Oxley Act

It has now become mandatory for US listed companies to have Sarbanes Oxley compliance. The companies need to meet Sarbanes Oxley compliance deadlines. The Sarbanes Oxley compliance states that the 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 system 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. Due to this improvement it helps to protect investor confidence in the companies and the US legislature as well. Moreover, it also helps in establishing a public company accounting oversight board, auditor independence, and corporate responsibility and enhanced financial disclosures.

The biggest expense involving 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 listing 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

4.1 Using the work of internal auditors

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 (Clarified) 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 holds sole responsibility for the audit opinion expressed on the financial statements.
4.1.1 Scope and objectives of internal auditing

The scope and objectives of internal auditing vary widely in accordance with the size, structure and objectives of the entity. Usually however, internal audit operates in one or more of the following broad areas:

(a) Review of the entity’s accounting and internal control systems
(b) Examination of financial and operating information
(c) Review of 3 Es (economy, efficiency and effectiveness) of operations (often referred to as performance auditing)
(d) Contributing in protecting assets against unauthorised use or disposal
(e) Review of compliance with laws and regulations
(f) Special investigations such as in the case of suspected fraud

4.1.2 Understanding and preliminary assessment of the role and scope of internal audit

External auditors are required to analyse the risks of material misstatement of the financial statements and to design and perform further audit procedures in order to gain evidence and form an independent opinion as to whether they form a true and fair picture of the entity's financial position and performance.

Internal auditors are an independent appraisal function established by management, therefore there is an inherent limitation on reliability. Therefore, an effective internal audit function may reduce, modify or alter the timing of external audit procedures, but it can never eliminate them entirely. The external auditor shall obtain a sufficient understanding of internal audit activities such as:

- the nature of the internal audit function’s responsibilities
- how the internal audit function fits into the entity's organisational structure
- the activities performed, or to be performed, by the internal audit function

In this way the auditor will be able to build up an understanding of the role and function of the internal audit department and how responsive management is to its findings. In particular, the auditor will consider the reporting structure. The external auditor will then base his assessment of audit risk and the risk of material misstatement on his findings.

The following criteria will be considered following important by the external auditors:

<table>
<thead>
<tr>
<th>Assessment of internal audit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Status within entity</strong></td>
</tr>
<tr>
<td><strong>Scope of function</strong></td>
</tr>
<tr>
<td><strong>Technical competence</strong></td>
</tr>
<tr>
<td><strong>Due professional care</strong></td>
</tr>
<tr>
<td><strong>Power in the entity</strong></td>
</tr>
<tr>
<td><strong>Communication</strong></td>
</tr>
</tbody>
</table>
4.2 Internal auditor's work

The objectives of internal audit differ from those of external auditors, as discussed at 1.1.1. However, some of the means of achieving their respective objectives are similar. External auditors may use internal auditors' work particularly in the following areas:

- Recording an accounting system
- Evaluating and testing internal control
- Substantive procedures
- Review

4.2.1 Timing of liaison and co-ordination

The timing of internal audit work, and its interaction with external auditors' work should be agreed as early as possible. There should be regular liaison with the internal auditors throughout the audit. Findings on tests and conclusions should be passed both from external audit to internal audit and vice versa.

4.3 Evaluating specific internal auditing work

When the external auditor intends to use the work of internal auditors, he should evaluate and perform audit procedures that work to confirm its adequacy.

The evaluation will consider the scope of work and related audit programmes and whether the assessment of the internal audit function remains appropriate. The auditor should document the work of internal auditors which have been used in the external audit.

Internal auditors should report to the whole board of directors or the audit committee and should be free to discuss their concerns with external auditors. They should not report to management upon whose work or responsibilities they are likely to comment, such as the Chief Financial Officer.

<table>
<thead>
<tr>
<th>Evaluation</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Training and proficiency</td>
<td>Have the internal auditors had sufficient and adequate technical training to carry out the work? Are they proficient?</td>
</tr>
<tr>
<td>Supervision</td>
<td>Is the work of assistants properly supervised, reviewed and documented?</td>
</tr>
<tr>
<td>Evidence</td>
<td>Has sufficient appropriate audit evidence been obtained to afford a reasonable basis for the conclusions reached?</td>
</tr>
<tr>
<td>Conclusions</td>
<td>Are the conclusions reached appropriate, given the circumstances?</td>
</tr>
<tr>
<td>Reports</td>
<td>Are any reports produced by internal audit consistent with the result of the work performed?</td>
</tr>
<tr>
<td>Unusual matters</td>
<td>Have any unusual matters or exceptions arising and disclosed by internal audit been resolved properly?</td>
</tr>
<tr>
<td>Plan</td>
<td>Are any amendments to the external audit plan required as a result of the matters identified by internal audit?</td>
</tr>
<tr>
<td>Testing</td>
<td>Has the work of internal audit been sufficiently tested by the external auditor to confirm its adequacy?</td>
</tr>
</tbody>
</table>

The nature, timing and extent of the testing of the specific work of internal auditing will depend upon the external auditor's judgment of the risk and materiality of the area concerned, the preliminary risk assessment of internal auditing and the evaluation of specific work by internal auditing. Such tests may include examination of items already examined by internal auditing, examination of other similar items and observation of internal auditing procedures.

If the external auditors decide that the internal audit work is not adequate, they should extend their procedures in order to obtain sufficient appropriate evidence.
Self-test question 1

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 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)

4.4 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 is focused on the operations of the entire business.

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

<table>
<thead>
<tr>
<th></th>
<th>Internal audit</th>
<th>External audit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objective</strong></td>
<td>Designed to add value and improve an entity's operations.</td>
<td>An exercise to enable auditors to express an opinion on the financial statements.</td>
</tr>
<tr>
<td><strong>Reporting</strong></td>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td><strong>Scope</strong></td>
<td>Work relates to the operations of the entity.</td>
<td>Work relates to the financial statements.</td>
</tr>
<tr>
<td><strong>Relationship</strong></td>
<td>Often employees of the organisation, although sometimes the function is outsourced.</td>
<td>Independence of the entity and its management. Usually appointed by the shareholders.</td>
</tr>
</tbody>
</table>
The table demonstrates that the whole basis and reasoning of internal audit work is fundamentally different to that of external audit work.

4.5 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, internal auditors 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 auditor plays an important role in the management of risk so he 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 auditor can help to prevent fraud by carrying out timely reviews on the adequacy and effectiveness of control systems and making appropriate recommendations. The internal auditor may be able to detect fraud by being mindful to the possibility when carrying out his 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.

4.6 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, ie 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.
• **Internal audit** assists management in achieving the entity’s corporate objectives, particularly in establishing **good corporate governance**.

• 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.

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

• Although many of the techniques internal and external auditors use may be similar, the basis and reasoning of their work is different.
Answer 1

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 auditors 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 (Clarified), external auditors should consider the following before relying on the work of internal auditors.

- External auditors should obtain sufficient understanding of the work of internal auditors
- External auditors should consider the organisation status, scope of function, technical competence and due professional care
- When internal auditing is relevant to the external auditor's risk assessment, perform an assessment of the internal audit function

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

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)

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. Arbitrary technique practising 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 with good quality. They are then more ready to face ethical dilemmas and carry out their responsibilities in a manageable way.
chapter 4
Code of Ethics

Topic list
1 Fundamental principles and the conceptual framework approach
2 Specific guidance: independence
3 Specific guidance: confidentiality
4 Specific guidance: conflicts of interest
5 Conflicts in application of the fundamental principles
6 Code of Ethics applicable to professional accountants in business
7 Other issues

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.
In this chapter you will cover the following learning outcomes:

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

The following summary illustrates the main parts of the chapter:

**ETHICAL REQUIREMENTS**

- **“Code of Ethics”**
  - **INDEPENDENCE**
  - **OBJECTIVITY**
  - **INTEGRITY**
  - **IDENTIFY THREATS TO INDEPENDENCE**
    - Self-Interest Threat
    - Self Review Threat
    - Familiarity Threat
    - Advocacy Threat
    - Intimidation Threat
  - **SAFEGUARDS AGAINST THREATS TO INDEPENDENCE**
    - By legislation and regulations
    - Firm wide
    - Engagement specific
  - **CONFIDENTIALITY**
  - **CONFLICT OF INTEREST**
    - **THE FIRM V THE CLIENT**
    - **CLIENT V CLIENT**
    - **OBLIGATION TO DISCLOSE**
    - **FREEDOM TO DISCLOSE**
  - **THE FIRM**
    - Obligated by law
    - Protect the firm’s interests
  - **THE CLIENT**
    - Provide safeguard to reduce the conflict
    - Decline the engagement
  - **OBLIGATION TO DISCLOSE**
    - Accept client
    - Protect the firm’s interests
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.

After a long consultation process, The Code of Ethics for Professional Accountants (the 'Code') became effective as of 30 June 2006. All members of the Hong Kong Institute of Certified Public Accountants (HKICPA) are required to comply with the Code, which is divided into four sections:

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section A</td>
<td>General Application of the Code</td>
</tr>
<tr>
<td>Section B</td>
<td>Guidance for professional accountants in public practice</td>
</tr>
<tr>
<td>Section C</td>
<td>Guidance for professional accountants in business</td>
</tr>
<tr>
<td>Section D</td>
<td>Additional local ethical requirements</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Professional accountant in public practice</th>
<th>Professional accountant in business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition</td>
<td></td>
</tr>
<tr>
<td>A professional accountant in firm that provides professional services.</td>
<td>A professional accountant employed or engaged in commerce, industry, service and so on.</td>
</tr>
</tbody>
</table>

Adoption of the Code Parts A, B and D  Parts A, C and D

Section A provides guidance on fundamental ethical principles where professional accountants are required to apply the conceptual framework to identify threats to compliance with the fundamental principles and to evaluate the significance of such threats.

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 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 professional accountant has a duty to serve not only, to act in the interests of the
entities he serves, but the wider public interest. Professional accountants must be, and must be seen to be, **independent**.

Professional accountants are relied on by the entities they serve, and the users of their financial statements. They need access to sensitive financial and strategic information which may have a significant impact on the future direction of the business and its stakeholders. Therefore, they have a duty of **confidentially** and must only disclose information in very exceptional circumstances discussed later.

Undertaking these professional obligations may give rise to **conflicts of interest** that is where an individual or firm has a vested interest in a particular business outcome. 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 (the HKICPA or Institute).

As it is impossible to anticipate all the scenarios which may give rise to these dilemmas the guidance is given in the form of fundamental principles, guidance and explanatory notes rather then prescriptive rules. 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. The principles are covered in more detail in the next section.

### 1.2 The fundamental principles

<table>
<thead>
<tr>
<th>HKICPA Code of Ethics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Integrity.</strong> A professional accountant should be <strong>honest</strong> and <strong>straightforward</strong> in all professional and business relationships. Integrity also implies <strong>fair dealing and truthfulness</strong>. Professional accountants should not be associated with information that contains a materially false and misleading statement or the information has been furnished recklessly.</td>
</tr>
<tr>
<td><strong>Objectivity.</strong> A professional accountant should not be <strong>biased</strong> nor have <strong>conflicts of interest</strong> or <strong>undue influence</strong> to override professional or business judgment. The professional accountant <strong>should not compromise</strong> professional or business judgment due to bias. In addition, they should avoid being exposed to situations that may impair objectivity.</td>
</tr>
<tr>
<td><strong>Professional competence and due care.</strong> A professional accountant should be <strong>competent</strong> to perform professional services and should <strong>act diligently</strong> 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.</td>
</tr>
<tr>
<td><strong>Confidentiality.</strong> 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 <strong>should not be used for personal advantage</strong> or for any third parties. There is a need to maintain confidentiality of information within the firm or within an employing entity. The duty of confidentiality continues even after the end of the relationship between the professional accountant and the entity.</td>
</tr>
</tbody>
</table>
Disclosure of information is allowed only when:

- permitted by law and authorised by the client 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, i.e.
  - 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

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 disparage 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.

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 client)

(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 audit team member is related to a key staff 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 regulations
(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 and partners, and set up 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 on 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) Disclosing 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 entities function through establishing business relationships with other professionals

(d) Use an independent mentor

(e) Maintain contact with legal advisers and professional bodies

2 Specific guidance: independence

Topic highlights

Section B of the Code of Ethics applies to professional accountants in practice. 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.

The guidance also recognises that there are occasions where no appropriate safeguard is available. In this case, 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 professional accountant must be, and be seen to be, independent. Independence is of vital importance to the audit and assurance profession. What does it mean in practice?
Key terms

Independence of mind: The state of mind that permits the provision 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: The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised.

Firms must evaluate the significance of any threats to independence and where possible put safeguards in place, to reduce the threat to an acceptable level. If it is not possible to put adequate safeguards in place, it is better to withdraw services rather than risk a conflict of interest. Listed entities, or those deemed to be of significant public interest, may be subject to more stringent rules.

Topic highlights

HKICPA's Code of Ethics gives scenarios where independence may be threatened and suggests protective safeguards.

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, but remember it is the spirit of the guidance, rather than its form, that is most important.

2.3 Self-interest threat

The HKICPA Code of Ethics has included a number of areas in which a self-interest threat might arise.

2.3.1 Financial interests

When considering whether a financial interest in a client constitutes a self-interest threat, the following factors should be considered when assessing whether the threat is significant:

- Degree of threat controlled by owner
- The role of the owner
- The materiality of the interest
Examples:

- Beneficial interest in shares / other interest
- Overdue fees
- Holding shares in a firm's client
- Being trustee of a trust that holds shares in the entity
- Having a retirement plan which owns shares in the entity
- A material indirect ownership of shares

**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.

A financial interest in an entity constitutes a substantial self-interest threat. According to HKICPA, the parties listed below are not allowed to own a direct financial interest or an indirect material financial interest in an entity:

- The firm
- A member of the assurance team
- An immediate family member (spouse or dependant) of a member of the assurance team

**Financial interest in an assurance firm may create a self-interest threat.**

**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 a 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

**Safeguards available to eliminate the threat or reduce it to an acceptable level:**

(a) Dispose of the direct financial interest before joining the engagement team
(b) Dispose of the indirect financial interest fully
(c) Dispose of a sufficient amount of the interest so it is no longer material before joining the engagement team
(d) Remove the member from the assurance engagement
(e) Keep the client's audit committee informed of the situation
(f) Use an independent partner to review work carried out if necessary

If a member of the assurance team or their immediate family members receive the financial interest without intention, e.g. through inheritance, gift or a merger, this will nevertheless create a self-interest threat.

**Safeguards available to eliminate the threat or reduce it to an acceptable level:**

(a) Dispose of the financial interest at the earliest practicable date
(b) Remove the member from the engagement team

When a close family member has a direct financial interest or a material indirect financial interest in the entity, self-interest threat is created.
Safeguards available to eliminate the threat or reduce it to an acceptable level:

(a) The immediate family member should dispose of all, or a sufficient amount of the financial interest, at the earliest practicable date

(b) Discuss the matter with the audit committee, or those charged with governance

(c) Use a professional accountant not involved in the assurance engagement to review the work performed

(d) Remove the member from the engagement team

Such matters involve the judgment of the engagements partners who are responsible for making decisions about ethical issues. This may mean, for example, determining 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 a 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 a range of methods to address this if it 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, a threat may arise and safeguards may be necessary. Whether a firm acting as a distributor or marketer of an entity’s products or services (or vice versa) constitutes a material interest will also depend on the degree of involvement and the effect overall of the transactions on both entities.

Where a degree of judgment is involved, unless the interest is clearly insignificant, an assurance provider should not participate in a venture with a client.

If the interest may be construed as material, ethical behaviour would dictate a termination of either the assurance provision or the other business relationship.

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 assurance team.

2.3.3 Employment with a client

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 within a client. Where an accountant has been connected with an audit at an client which subsequently offers them or may offer employment objectivity may be impaired by the motivation to impress a potential future employer.

A Chief Financial Officer who worked previously as an audit partner has too much knowledge of the audit firm's systems and procedures to perform independently.

Here too, deciding the significance of the threat to independence depends on the specific circumstances:

(a) The degree of influence the individual held over the audit in the past

(b) The time interval between the audit and the acceptance of the employment

(c) The capacity for influence the appointment gives the professional accountant over the subject matter of the assurance engagement.
Safeguards available to eliminate the threat or reduce it to an acceptable level:

(a) A partner should not accept a key management position at any client with which he has been involved until at least two years have elapsed since the conclusion of the audit with which he was connected.

(b) An individual who has moved from the firm to a client should not be entitled to any benefits or payments from the firm unless these are made in accordance with pre-determined arrangements. If money is owed to the individual, it should not be so much as to compromise the independence of the assurance engagement.

(c) A firm should 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.

(d) Modification of the assurance plan

(e) Reassigning the engagement to another professional accountant with appropriate expertise

(f) Involving an additional independent professional accountant to review the work performed

(g) Carrying out a quality control review of the engagement

2.3.4 Partner on entity board

A partner or employee of the firm should not serve on the board of an entity. There are limited extenuating circumstances, such as whether the partner serves in a purely administrative role, for example as company secretary.

2.3.5 Family and personal relationships

We have already touched on the self-interest threat created by direct and indirect financial interest, and by close business relationships. The threat is equally great with close family and personal relationships. 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

(b) 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.

(c) The closeness of the relationship, (according to the definition given in the Code immediate family constitutes spouse and dependants)

(d) The role of the other party at the entity

(e) 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 a close family relationship is disclosed it is usually appropriate to remove the individual from the assurance team.

A firm should have quality control procedures under which employees are required to disclose if a close family member employed by a client is promoted. Where the more senior post may increase 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

Gifts and hospitality is a notoriously difficult area; in some parts of the world place offering gifts or corporate hospitality is an accepted part of business life; in others, it falls into a grey area somewhere between inducement and bribery. In general, unless the value of the gift or hospitality is clearly insignificant a member of an assurance team should decline an offer which may be construed as intended to influence judgment.

2.3.7 Loans and guarantees

The advice on loans and guarantees is similar to that on business transactions. 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, such as a mortgage, is likely to be material, 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.

2.3.8 Overdue fees

If fees remain overdue the assurance firm runs the risk of, in effect, offering a loan to a client. This then creates a financial interest in the entity, which is not permitted.

**Safeguards available to eliminate the risk or reduce it to an acceptable level:**

(a) An independent review to ensure that the fees charged are fair for the work performed
(b) Policies should be in place to ensure that unpaid fees do not build up to unfeasibly high levels
(c) Unpaid fees should be discussed with the client's senior management promptly
(d) If the fees remain unpaid then the firm should consider resignation

2.3.9 Contingent fees

**Key term**

**Contingent fees** (or percentage fees) are fees which are calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed.

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.

However, there are some circumstances where it may be appropriate to accept a contingent fee for non-assurance work if suitable safeguards are in place. Safeguards available to eliminate the risk or reduce it to a suitable level:

- Making disclosures to the audit committee about the fees
- Review or determination of the fee by an unrelated third party
- Quality control policies and procedures

Whether a contingent fee is acceptable for non-assurance engagements depends on the following factors:

- The range of possible fee outcomes
- The degree of variability in the fee
- The basis on which the fee is to be determined
• Whether the transaction is to be reviewed by an independent third party
• The effect of the transaction on the assurance engagement

2.3.10 Undue dependence on total fees

A self-interest threat arises where the total fees generated by a client represent a large proportion of a firm's total revenue.

The public may perceive that a firm's objectivity is likely to be in jeopardy where the fees for audit and recurring work paid by an entity or group of connected entities exceeds 15 per cent of the firm's total fees. If the entity is listed or is otherwise deemed to be of public interest, this figure is lowered to 10 per cent.

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 a particular entity represent a large proportion of the revenue brought in by an individual partner.

Safeguards available to eliminate the risk or reduce it to an acceptable level:

(a) Discussion of the matter with the client's senior management or the audit committee, if it has one
(b) Taking steps to reduce the financial dependency on the client
(c) Obtaining external or internal quality control reviews
(d) Consulting an external party, such as HKICPA

2.3.11 Lowballing

Key term

Lowballing is the term used to describe the situation where a firm quotes a significantly lower fee for an assurance service than would be charged by a competitor firm usually in order to gain other more lucrative business.

The audit and assurance market is highly competitive and firms are entitled to set their fee levels as they wish in order to attract business. However, when they do this by reducing their fee level to one below market rates, the question of a self-interest threat arises. If the firm goes on to perform the work tendered for it must ensure that the low fee income must not adversely impact on the quality of the review.

Safeguards available to eliminate the risk or reduce it to an acceptable level:

(a) 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
(b) Demonstration that the assurance engagement complied with all applicable assurance standards, guidelines and quality control procedures

Lowballing is a risky strategy which may result in the firm being forced to make a choice between losing money or compromising on quality if the other business the firm hoped to win on the back of the loss-making audit does not materialise.

2.3.12 Significant low fee

As with lowballing 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.

In determining whether the firm has complied with ethical standards 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
- 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.

**Self-test question 1**

FF Limited has decided to put their audit out to tender and has asked your firm S & S Partners and one other firm to participate in the tendering process. You become aware that the other firm has submitted a tender with a fee 50 per cent less than your preliminary fee estimate. Your tender has not yet been submitted. You are concerned that if you submit your tender as it stands, there will be no chance of winning the audit.

**Required**

(a) Discuss the ethical issues involved in relation to the other firm's fee estimate.
(b) What action would you take as a result of the above?

(The answer is at the end of the chapter)

### 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 Actual or threatened litigation

A firm's objectivity may be threatened, or appear to be so, when the firm is involved in litigation with a client. Litigation represents a **breakdown of the relationship of trust**. Directors of the client will be reluctant to disclose information to the firm of professional accountants who may rely on it during proceedings.

If the threatened litigation is to sue the firm of professional accountants for negligence, the firm has no option but to resign.

There are no **appropriate safeguards** to reduce the threat to an acceptable level; the only appropriate action is to withdraw from the engagement and:
(a) disclose the extent and nature of the litigation to the audit committee or those charged with governance
(b) if there is a member of the assurance team involved in the litigation, he should be removed from the engagement team
(c) engage an additional professional accountant to review work done
If the litigation relates to unpaid fees, professional accountants do not necessarily have to resign but see 2.3.8 above.

2.3.15 Receiving or paying referral and commission

Paying a commission or referral fee or accepting a fee of this kind is permitable. However, a self-interest threat may arise and objectivity, professional competence and due care may be called into question:

Safeguards available to eliminate the threat or reduced it to an acceptable level:

(a) Disclose to the client the arrangement to pay/receive a referral fee to another professional accountant for the work passed onto them
(b) Obtain advance agreement from the client for commission arrangements in connection with the sale by a third party of goods or services to the client

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, and then being asked to evaluate their effectiveness, 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 offer, so the risk of self-review has increased. The table below summarises some of the services that may be provided and is followed by discussion about how the provision of these may impair independence.
Services which may be provided by professional accountants

<table>
<thead>
<tr>
<th>Services</th>
<th>Risk of self-review</th>
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<tr>
<td>Bookkeeping</td>
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<tr>
<td>Preparation of financial statements</td>
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<tr>
<td>Tax services, although generally these are not seen to impair independence</td>
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<tr>
<td>Design and implementation of financial information systems</td>
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<tr>
<td>Appraisal, valuation services and fairness opinions</td>
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<tr>
<td>Actuarial services</td>
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<td>Internal audit services</td>
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<tr>
<td>Management functions, but there are strict rules in the HKICPA Code (see bold text) about the degree to which assurance advisers may intervene in the management decisions of the entity</td>
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<tr>
<td>Human resources – such as recruitment and selection of senior management, provision of temporary staff cover and so on</td>
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<tr>
<td>Corporate finance, broker-dealer services, accessing finance and so on</td>
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<tr>
<td>Legal services and litigation support</td>
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For listed or public interest entities the rules are much more stringent. These terms are defined below.

Key terms

**Listed entities** are those whose shares have been admitted to a recognised exchange, such as the Stock Exchange of Hong Kong.

**Public interest entities** are those which for some reason (size, nature, product) are in the 'public eye'. Professional accountants should treat these as if they are listed entities.

### 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 a client:

**Individuals who have held the role of director or served as an officer of the client, 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 client 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 client has one.

### 2.4.2 General other services

Another rule defines the scope of a firm's services for a client:

**For clients, 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 a client's assets, supervising the client's employees in the performance of their normal duties, and preparing source documents on an client's behalf are a common requirement for assurance firms which could also pose significant self-review threat.

Safeguards available to eliminate or reduce the risk to an acceptable level:

(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 professional accountants 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

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.

For listed or public interest an assurance firm should not prepare accounts or financial statements for listed or public interest entities, except in very exceptional circumstances. 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 available to eliminate or reduce the risk to an acceptable level:

- Using staff members other than assurance team members to carry out work
- Obtaining entity approval for work and underlying assumptions undertaken

However, for any entity, firms are never permitted 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 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.

**Safeguards available to eliminate or reduce the risk to an acceptable level:**

(a) Second partner review
(b) Confirming that the entity understands how the valuation is reached and the underlying assumptions
(c) Ensuring the entity acknowledges its responsibility for the valuation
(d) Using separate staff for the valuation and the audit

### 2.4.5 Taxation services

Generally, the provision of taxation services is not seen as any threat to independence.

### 2.4.6 Internal audit services

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 its 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 audit team

### 2.4.7 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 client’s shares under any circumstances. Similarly, it is also not allowed for a firm to commit a client to the terms of a transaction or consummate a transaction. There are other corporate finance services, such as 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, and making sure policies are in place to prevent management decisions being taken on behalf of the client.

### 2.4.8 Other services

Among the other services a firm might offer to client's are:

- IT services
- Temporary staff cover
- Litigation support
- 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 is seconded to cover the Chief Financial Officer's maternity leave. Before you read on, consider what would you regard as the appropriate ethical behaviour in these two circumstances.
2.5 Advocacy threat

An advocacy threat often arises in the provision of legal or corporate finance services. To avert this threat firms must avoid being in the position of taking the client's part in a dispute or otherwise acting as their advocate in a way that threatens the appearance of independence. A legal example is where a firm has provided legal services and later defends a client. Corporate finance examples are where the firm gives advice on debt reconstruction and negotiates with the bank on the client's behalf or deals or acts as a promoter of shares for a client. These are instances where a professional accountant may promote, or may be seen to promote, a client's position to the point that objectivity may be impaired.

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 client and its employees. Professional scepticism may be severely impaired in circumstances.

2.6.1 Long association of senior personnel with clients

A long association with a client 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 its staff and clients, including requirements to disclose any promotions or changes within the clients which may introduce a new risk (as discussed earlier). 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:

(a) The engagement partner should be rotated after a pre-defined period

(b) 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

(c) The individual responsible for the engagement quality control review should be rotated after a pre-defined period

If a client 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 size constraint may mean rotation is impracticable or reliance on a key person's expertise would mean the risk of detriment to technical quality by not involving them is greater than the risk derived from the earlier connection. In this case, the firm must devise suitable safeguards to make sure independence is preserved.

### 2.7 Intimidation Threat

An intimidation threat arises when members of the assurance team are intimidated or put under pressure to act unethically by a client's directors.

- Close business relationships
- Litigation
- Assurance staff members move to employment with client
- Family and personal relationships

A professional accountant may be dissuaded from using objectivity and exercising professional scepticism by threats, whether actual or perceived from directors of an client.

There are three main types of threat:

(a) **Loss of business:** For instance, as a result of a disagreement over the application of an accounting principle, the client may threaten to change its auditors if they wish to modify their report as a result of the dispute.

(b) **Loss of fee revenue:** For instance, the client may apply pressure to reduce the extent of work performed by the professional accountants unjustifiably in order to reduce the fees. The risk of intimidation is much higher if there is undue dependence on fees, and the firm is under pressure to placate the client in order to keep the business.

(c) **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

Ligation, threatened or real, has serious implications for firms: the loss of the immediate client, the time and expense involved in litigation, and the damage to reputation and loss of other clients, even if the claim 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.

Good control systems should prevent such situations arising. If litigation is threatened, or actioned, the following assessments need to be made:

- The materiality of the litigation
- The nature of the assurance engagement
- Whether the litigation relates to a prior assurance engagement

**Safeguards available to eliminate or reduce the risk to an acceptable level:**

(a) Disclosing to the audit committee or those charged with governance the nature and extent of the litigation

(b) Removing specifically affected individuals from the engagement team

(c) Involving an additional professional accountant on the team to review work

2.7.2 Second opinions

A client 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 not able to give a formal audit opinion on the financial statements. However, if 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 entity's 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 client 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 available to eliminate or reduce the risk to an acceptable level:**

- Obtain the client's consent
- Describe the limitations surrounding any opinion in communications with the client
- Provide the existing firm with a copy of the opinion

**Self-test question 2**

(a) Mr Chan is a partner of a large international audit firm. One of the clients is ABC Limited ("ABC"), a large multinational corporation. Recently, Mr Chan was happy that his daughter was engaged to Mr Yeung who is the financial controller of ABC. Mr Chan is concerned about the independence issue and is considering withdrawal from the engagement team for the current year. The interim work has been completed with no major problems.
Required
Discuss whether Mr Chan is obliged to withdraw from the engagement team in the current financial year.

(b) Assume Mr Chan has withdrawn from the engagement team. One of the audit managers, Alan, responsible for auditing ABC, has discovered that the management of ABC might not have complied with certain laws. After discussion and review of labour costs expenses, Alan suspects that ABC might have employed illegal workers in order to reduce labour costs. ABC’s operational staff has confirmed to Alan that this is the practice adopted.

Alan also suspects that ABC might have bribed the staff of its customers as some unexplained payments appear in ABC's records. Alan's university classmate, Dave, who works in the Independent Commission Against Corruption (ICAC), calls Alan to request information about ABC.

Required
Should Alan disclose the possible offences of ABC to Dave?

(c) Recently, Alan has also been appointed as the manager-in-charge of the engagement for the flotation on the GEM of a high technology company, BT Company. The firm would be responsible for reporting on the trading results of BT. The partner told Alan that the firm's engagement is for listing work. Its success would help to promote the firm to existing and new clients who are considering listing. The firm would provide audit, tax and company secretarial work for BT. A non-appointment would cause a loss of approximately 10 per cent of the firm's annual revenue.

Required
Should the firm accept the BT engagement?  
(The answer is at the end of the chapter)

2.8 **HKSQC 1: Quality control: Independence**

HKSQC 1 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

The standard sets out some detailed requirements with regard to independence.

The firm should 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 experts contracted by the firm and network firm personnel), maintain independence where required by the *Code*. Such policies and procedures should 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 should require:

(a) Engagement partners to provide the firm with relevant information about entity 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

The firm should 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 should include requirements for:

(a) All who are subject to independence requirements 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 (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 should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the HKICPA Code.

2.8.1 Familiarity threat

Last, the HKSQC 1 sets out some specific guidance in relation to the threat of over-familiarity with clients.

The firm should 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) For all audits of financial statements of listed clients, requiring the rotation of the engagement partner after a specified period in compliance with the Code.
3 Specific guidance: confidentiality

Topic highlights
HKICPA recognises a duty of confidence and several exceptions to it.

3.1 Duty of confidence

A professional accountant has a duty of confidentiality to his client. This principle is encased 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 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 client to have committed a default or a criminal act he is obliged to disclose all the information at his disposal to a competent authority.

A professional accountant must disclose information if compelled to do so by a court order (process of law).

If a professional accountant 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 ascertain 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 permission is declined, legal advice may need to be sought. Any notice served directly to the professional accountant for obtaining documents related to the entity, should be read carefully and legal advice sought if necessary.

A CPA 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 under 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 (with the exception of 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 individual or entity whom he knows or believes to have committed an indictable offence.

A professional accountant should not normally appear in court as a witness against an entity unless a written court order is served.

A professional accountant 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, as defence 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 a client

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 HKICPA 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 HKICPA should take into account when deciding whether to make disclosure.

**HKICPA guidance: factors determining disclosure**

- 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

### 3.3.1 Unlawful acts or defaults by or on behalf of a member’s employer

If a HKICPA 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 CPA has a general duty to his employer to act in good faith and with a duty of confidence.
The employed CPA should not generally disclose any confidential information without the entity's consent.

**Self-test question 3**

You are the senior manager in a medium-size CPA firm. You are responsible for the audits for the following client 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 20Y0.

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 client'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. 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 clients' interests

A conflict between professional accountants' and clients' interests may arise if a firm of professional accountants are in direct competition with a client, or else are involved in a joint venture with one of the client'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 clients.** 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 client**. Special care should be taken that any advice given is in the client's best interests.

4.2 **Conflicts between the interests of different clients**

There is nothing improper in a firm serving two or more client's whose interests are in conflict, as long as the work of 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 client do not adversely affect the other. **Where acceptance or continuance of an engagement would, even with safeguards, materially prejudice the interests of any client, the appointment should not be accepted or continued.**

Material prejudice may mean information being leaked or for firms to be forced into a situation 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 client's 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 client. It is then the decision of the client as to whether to continue with the firm with the safeguards in place or to seek an alternative provider.

Particular difficulties can arise when it comes to share issues, and takeovers. Professional accountants are often justly 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**, where the professional accountants audit the accounts of both or offeror and target company, they must ensure that they 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.

*Safeguards available to eliminate risk or reduce it to an acceptable level:*

(a) Disclosing to the entity the 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

(d) Using separate engagement teams

(e) Procedures to prevent access of information (such as secure passwords and firewalls)

(f) Clear procedures for the respective teams on issues of security and confidentiality

(g) The use of confidentiality agreements signed by the partners and staff

(h) Regular review of the safeguards by an independent partner

(i) 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 engagement.

Self-test question 4

You are an audit manager in MKJ & Co, a local CPA firm. Your firm has been approached by a new client, 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 counsel.

If after exhausting all relevant possibilities, the ethical conflict remains unresolved, HKICPAs should consider withdrawing individually from the engagement or specific assignment, or the firm should relinquish the engagement.

6 Code of Ethics applicable to professional accountants in business

Topic highlights

Professional accountants in business face similar threats to professional accountants in public practice. Section C of the Code of ethics relates 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 an executive or non-executive position.

He may be:

- a salaried employee, partner, director, owner or may work for many entities
- solely or jointly responsible for preparing and reporting financial and other information for his employer or any persons relying on the information
- responsible for providing effective financial management and competent advice for investors, creditors, employers or government departments
- charged with the responsibility to further legitimate aims of their employing entity
- expected to encourage an ethics-based culture and environment in an employing entity that emphasises the importance of ethical values; and

In addition, he 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 which 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 threats to compliance with the fundamental principles for a professional accountant in business.

6.1.1 Self-interest threat

The following are examples of a self-interest threat:

(a) Holding a financial interest in, or receiving a loan or guarantee from the employing entity;
(b) Participation in incentive compensation arrangements offered by the employing entity;
(c) Inappropriate personal use of corporate assets;
(d) Consideration of employment security; and
(e) Commercial pressure from outside the employing entity.
6.1.2 Self-review threat
One example of a self-review threat is a professional accountant being asked to consider an appropriate accounting treatment for a business combination after performing the research study that supported the acquisition decision.

6.1.3 Familiarity threat
(a) The professional accountant in business faces a familiarity threat if he is responsible for auditing or determining the accounting treatment behind the employing entity's financial statements when an immediate or close family member is employed by the entity in a capacity to make decisions that would affect the entity's financial reporting;
(b) Long association with business contracts affecting business strategy; and
(c) A professional accountant in business accepting a material gift or hospitality, unless the value is trivial and inconsequential.

6.1.4 Intimidation threat
An intimidation threat may arise in the following situations:
(a) 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 policy or the way in which financial information is to be reported; and
(b) 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 client, professional accountants in business may legitimately promote the client's goals. If the statements made are neither false nor intended to mislead, 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:
(1) Safeguards created by the profession, legislation or regulation; and
(2) Safeguards in the working environment.
Safeguards in the work environment include:
(a) employing entity’s systems of corporate oversight or other oversight structures
(b) employing entity's ethics and conduct programs
(c) recruitment procedures in the employing entity emphasising the importance of employing highly competent staff
(d) strong internal controls
(e) appropriate disciplinary processes
(f) strong leadership to emphasise the importance of ethical behaviour and expectation that employees will act ethically at all times
(g) policies and procedures to implement and monitor quality of employees
(h) employees updated for any changes in policies and procedures
(i) appropriate training and education in implementing such policies
(j) policies and procedures to encourage employees to communicate to senior management within the employing entity; and

(k) consultation with 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 entity and professional obligations to comply with the fundamental principles.

The professional accountant in business may be under **pressure** when requested to:

(a) act contrary to law or regulation, technical or professional standards;

(b) facilitate unethical or illegal earning management strategies;

(c) lie to or intentionally mislead others such as auditors or regulators; and

(d) 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:*

(a) Obtain advice from the employing organization, an independent professional adviser or a relevant professional body;

(b) Initiate a formal dispute resolution process within the employing entity; and

(c) 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 to professional standards so that the information will be understood in its context.

A professional accountant in business shall maintain the information for which he is responsible in the manner which ensures it:

- 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 into becoming associated with misleading information through the actions of others (self-interest or intimidation threats) safeguards may be taken such as:

- **consultation with superiors** within the employing entity or with a relevant professional body

If it is not possible to apply safeguards, the professional accountant in business should refuse to remain associated with information he regards as misleading. 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 he possesses and should seek appropriate advice and assistance when required.

Circumstances when there is threat against performing duties with an appropriate degree of competence and due care are when there is:
(a) insufficient time for properly performing or completing the relevant duties;
(b) incomplete, restricted or otherwise in adequate information for performing the duties properly;
(c) insufficient training, experience and education; and
(d) inadequate resources for the proper performance of the duties.

Safeguards available to eliminate the threat or reduce it to an acceptable level:
(a) Obtain additional advice and training;
(b) Ensure sufficient time to complete duties; and
(c) Consult, where appropriate, superior, independent experts, regulatory and professional body.

When the 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 where financial interests may create conflict are where the professional accountant in business:
(a) holds a direct or indirect financial interest in the entity and the value of the financial interest could be directly affected by decisions made by the professional accountant;
(b) is eligible for a profit related bonus which could be directed affected by the professional accountant's decisions;
(c) holds directly or indirectly share options in the entity which will be converted; and
(d) share options will be qualified when performance targets are met in the entity.

Safeguards available to eliminate the threat or reduce it to an acceptable level:
(a) Disclose all relevant interests and any future plans to trade in relevant shares to those charged with governance;
(b) Policies and procedures and creation of an independent committee to determine the level or form of remuneration of senior management;
(c) Consultation with, where appropriate, superiors, independent experts, regulatory and professional bodies or those charged with governance;
(d) Internal and external audit procedures; and
(e) Regular training 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 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.
6.7.1 Receiving an offer

The self-interest threat (or threat to 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 confidentiality threat) 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.

6.7.2 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 entity, 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.

7 Other issues

Topic highlights

There are other issues that a professional accountant must consider when entering into any relationships with a client. Among these are whether acceptance of any client, engagement or insolvency position causes a breach of any of the fundamental principles.

7.1 Client acceptance

Before accepting a new engagement, the professional accountant in public practice should consider whether there is any threat to compliance with the fundamental principles, for example, client 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 client engagements, acceptance decisions should be reviewed annually.

7.2 Engagement acceptance

A professional accountant must only accept an engagement that he is competent to perform.
Safeguards may be applied:
(a) 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;
(b) Obtain and be **familiar with the relevant regulations** or reporting requirements;
(c) Assign **sufficient competent staff**;
(d) Consider the use of **experts**;
(e) Consider the **deadline**; and
(f) 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 these:
(a) Discuss client's affairs with existing professional accountant;
(b) **Inquire from the existing professional accountant** as to any information the nominee should be aware of before deciding whether to accept the engagement;
(c) Before contacting the existing accountant, the **client must give their consent**; and
(d) For any client information to be released by the existing firm, the client's consent must first be sought unless there is a legal or ethical requirement for the 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 in comparison with the work of another professional accountant.

### 7.5 Custody of client's assets

A professional accountant should not keep, in custody, client's monies or other assets unless permitted to do so. For instance, if money is held on behalf of a client the following safeguards are available:
- Keep it separately from personal and firm's assets;
- Only use the assets for intended purpose;
- Keep proper accounting records for the assets; and
- Comply with laws and regulations.

### 7.6 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.

#### 7.6.1 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
- obtain confidential information
An intimidation threat (or 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.

### 7.6.2 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 assurance firm, 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
- Advise immediate or close family members of the situation after receiving such inducements

### 7.7 Integrity, objectivity and independence in insolvency

#### 7.7.1 Receivership and liquidator appointment

When a material professional relationship with a client 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 if it is insolvent or a trustee in bankruptcy.

#### 7.7.2 A material professional relationship exists

Where the partner/employee of the firm is prohibited from appointment as receiver, manager, liquidator or trustee for two years after the relationship has ceased.

#### 7.7.3 Material professional work

Constitutes 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.
• Professional accountants require an ethical code because they hold positions of trust, and people rely on them.
• The HKICPA’s Code of Ethics gives examples of a number of situations where independence might be threatened and suggests safeguards to independence.
• HKICPA recognises a duty of confidence and several exceptions to it.
• HKICPA gives further guidance on disclosure ‘in the public interest’. Firms should usually seek legal advice before making disclosures.
• Professional accountants in practice or in business should identify potential conflicts of interest as they could result in ethical codes being breached.
Answer 1

(a) When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee deemed to be appropriate.

The fact that the other firm quotes a fee 50 per cent lower than your firm is not in itself unethical.

If S & S Partners follows the other firm to lower fee by 50 per cent, there may be threats to compliance with the fundamental principles arising from the low level of fees quoted.

For example, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

The significance of such threats will depend on factors such as the level of fee quoted and the services to which it applies. The difference of 50 per cent is likely to be other than insignificant, unless S & S Partners’ preliminary fee estimate is itself excessively high.

If S & S Partners revises its fee quotation in order to win the tender, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Safeguards which may be adopted include:

(i) making the entity aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee

(ii) assigning appropriate time and qualified staff to the task

(b) The audit tender should be reviewed thoroughly to ensure that the fee estimate is a fair reflection of the time required and the quality of staff needed to adequately perform the audit. It may be possible to make legitimate cost savings and reduce the fee a little, as it may represent a fair fee for the service offered. If so, it should be submitted. There should be no attempt to compete with the other firm based purely on price.

Answer 2

(a) The Code of Ethics (‘the Code’) sets out that a professional accountant should comply with the fundamental principles. The relationship between Mr Chan and Mr Yeung may create a self-interest threat, an intimidation threat and a familiarity threat.

The familiarity threat arises because Mr Chan would be too sympathetic to Mr Yeung’s interest to be objective. The intimidation threat occurs because Mr Chan may be deterred from acting objectively and exercising professional scepticism by threats, actual or perceived, from Mr Yeung or other directors. The significance of the threat will depend on Mr Chan’s responsibilities in the engagement, the closeness of the relationship and Mr Yeung’s role in ABC. Since Mr Yeung is acting as the financial controller who has a direct and significant influence on the preparation of ABC’s accounting records and financial statements, and he is about to become Mr Chan’s son-in-law, the threat appears to be significant.

Mr Chan should consider whether the threats to independence are so significant that no safeguard could reduce the threats to an acceptable level; in which case, he should resign.

If Mr Chan does not feel it necessary to withdraw from the engagement team, appropriate safeguards should be implemented such as restructure the responsibilities of the engagement team or add quality control reviews.
(b) Alan should comply with the fundamental principle of confidentiality. He 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.

The firm is required to disclose information if compelled by process of law ie court order. Alan should first ascertain whether or not the person requesting information has a statutory right to demand it.

In this case, Dave does not seem to have the statutory right to request information from Alan unless there is a court order granted. Alan should not voluntarily disclose the information before taking appropriate legal advice.

(c) It is a fundamental ethical principle that a professional accountant has a continuing duty to maintain professional knowledge and skill. According to the case, the firm does not have any listed entities as clients at present; therefore the firm should consider whether the team members have the professional competence required to perform the potential listing work.

The fact that if successful, BT would be the firm's first listed entity, may cause a self-interest threat as BT's fee would account for approximately 10 per cent of the firm's annual revenue.

Appropriate safeguards should be applied such as:

(i) discuss the fee level with the audit committee and those charged with governance;
(ii) reduce undue dependence by only performing the audit; and
(iii) external quality review

If there are no safeguards, the firm should decline the engagement.

Answer 3

Management has decided not to recall any products and this indicates problems with management's integrity. The defects in the products have potential effects on Johnco's customers. Ethically, it would still be appropriate to announce the problem, allowing customers to return potentially harmful products. There might still be defective stock in Johnco's warehouses, waiting to be sold. Professional accountants should try to explain to management the reasons why they should disclose and convince management that this is the way to proceed.

If management still refuses 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, 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 client acceptance procedures. In considering accepting Washington as its client, 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 per cent of its recurring practice income (assuming advisory work, taxation and consultancy work to be performed annually) should be derived from Washington. Obtaining over 10 per cent 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 per cent 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 in the area of financial accounting.

Familiarity threat

The familiarity threat may occur when there exists a close relationship with a client, its directors, officers or employees; a firm or a member of the assurance team becomes too sympathetic to the client’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 a client who is also a competitor of Washington. There is nothing improper in a firm having two or more clients 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 client adversely affecting the other. The firm should review its relationship with prospective client, ie Washington and the rival client before accepting/continuing the engagement. If a material conflict of interest is identified, the firm should disclose sufficient information to both clients so that they can make an informed decision as to whether to continue with 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 per cent of its total fee of the firm. If there is undue dependence on Washington, MKJ should be selective of the engagements.
MKJ & Co should apply appropriate safeguards – specifically the firm should not act in a management capacity, making managerial decisions. The rule should be strictly adhered to as Washington would 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, as the employee is to become Human Resources Manager, there is very little direct and significant influence over the financial accounting function. 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 do so.
Super Gain Limited

You are the manager in charge of the audit of the financial statements of Super Gain Limited ('Super Gain'). Super Gain is a private company incorporated in Hong Kong and is engaged in the logistics business. Management of Super Gain plans to offer its securities on The Stock Exchange of Hong Kong Limited (the ‘Stock Exchange’) in the near future and has asked your firm to submit a proposal, including fee structure, for appointment as Super Gain's reporting accountants.

The Chief Financial Officer of Super Gain has asked you to include the following in your proposal:

(a) Your firm agrees to offer a flexible price structure of $1.5 million, payable in three instalments with the last instalment payable only upon the successful listing of Super Gain's shares on the Stock Exchange showing your firm's commitment in sharing risks with Super Gain in the flotation exercise; and

(b) Your firm agrees not to charge for any additional work that might be found necessary during the flotation exercise; and

(c) Your firm agrees to participate in the Super Gain road show with Super Gain's sponsor, and assist management to respond to questions from interested investors on Super Gain's financial matters.

Required

Comment on the potential issues surrounding your proposal to serve as the reporting accountants of Super Gain and how you would explain to Super Gain's Chief Financial Officer that the proposal has to be revised.

(13 marks)

HKICPA September 2004 (amended)
chapter 5

Framework for assurance engagements

Topic list

1 Overview of the Hong Kong Framework for Assurance Engagements
2 Assurance engagements
3 The purpose of external audit engagements
4 Reviews and other assurance 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:

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1 Overview of the **Hong Kong Framework for Assurance Engagements**

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 as at 28 June 2010.

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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 **Explain the importance of 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 (‘HKSAs’) 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**

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.

Key term
An assurance engagement is 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.

2.3 Assurance engagement or not?

2.3.1 A three party relationship

An assurance engagement must involve a three party relationship. 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 be:

- standards or benchmarks used to evaluate the subject matter of assurance engagements
- formal ie criteria may be Hong Kong Financial Reporting Standards or other applicable law
- suitable for enabling consistent evaluation (relevant to engagement circumstances)
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.

'Sufficiency' is about the **quantity** of evidence.

'Appropriate' is about **quality** of evidence (relevance and reliability).

2.3.5 **Written assurance report**

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

We shall look at risk in more detail in Chapter 8.

2.4 **Types of assurance engagements**

**Topic highlights**

Assurance engagements may give reasonable assurance or limited assurance.

The HKSAE 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**.

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.

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).

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 be believe that the financial statements are not true and fair…). Normal procedures would be limited to analytical procedures and inquiries.

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) 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 our 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 HKSCQ 1 (Clarified).

The standard requires that practitioners ensure they comply with the Code of Ethics for Professional Accountants and the Quality Control Standard (HKSCQ 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 an 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

The objective 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 objective of an audit of financial statements is to enable the professional accountant to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, giving a true and fair view of the entity's financial position at the period end and of the results of its operation for the period ended. 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 that 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 should:

(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 placed 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 control** on their reliability and effectiveness in practice.

Step 4
**Test the accounting system and internal control** 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 audit

Audits only give **reasonable assurance** that the financial statements are free from material misstatements.

The diagram below illustrates the limitations of auditing:

- **Professional judgments** have to be made:
  - Audit option
  - What to test?
  - Risk assessment
  - How much to test?

- **Audit evidence sometimes is only probable and not certain**:
  - Judgment; and
  - Estimates

- **Audit report is issued after a long time after the date of the statement of financial position**:
  - Up to date position is not enhanced

- **Audit report has inherent limitations**:
  - Standard format

- **Limitations in accounting and control systems**:
  - Non-routine transactions
  - Human error
  - Collusion and fraud
  - Trade-off of cost and benefit
  - Override of controls

- **Only selected items in the financial statements are tested**:
  - What to sample?
  - Sampling risk

### 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. The professional accountants are not responsible for establishing whether the financial statements are correct in every particular case. 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

Materiality is an expression of the relative significance or importance of a particular matter in the financial statements as a whole.

Any material matter if its omission or misstatements would reasonably influence the decisions of users. Materiality has both quantitative and qualitative aspects. A misstatement can be quantitatively immaterial but qualitatively material e.g. omission of disclosure of major litigation.

Materiality level is determined at the planning stage to ensure any material misstatement in the financial statements can be discovered. Materiality level must be considered by the firm in order to determine the nature, extent and timing of audit procedures and to evaluate the effect of misstatements discovered.

Some useful guidelines of materiality level are given below:

- 10% per cent of pre-tax profits (normal criteria and applicable to most entities)
- 5% per cent of gross profits (applicable to trading entities)
- 0.5–1% per cent of turnover
- 0.5–1% per cent of total assets (applicable to asset holding companies)

Other factors should be considered.

The assurance given by the firms is governed by the fact that the firms use 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

Firms 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 cast 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 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 enable a professional accountant to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the professional accountant's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

The Preface requires that HKSREs are to be applied in the reviews of historical financial information. HKSRE 2400 Engagement to Review Financial Statements should be applied when a professional accountant, other than the auditor of an entity undertakes an engagement to review 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 a later chapter.

4.2 Assurance engagements not dealing with historical financial information
It is HKSAE 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 HKSAE 3000 are compliance engagements and performance audits. Further details will be covered in Chapter 18.

4.3 Investment circular reporting engagements
The Preface requires that HKSIIRs are to be applied in investment circular reporting engagements.
Under HKSIR 300 Accountants’ Reports on Pro Forma Financial Information in Investment Circulars, professional accountants should include in the accountants’ report a clear expression of opinion on the pro forma financial information. For HKSIR 400 Comfort Letters and Due Diligence Meetings on Financial and Non-financial Information, no assurance is expressed.

5 Non-assurance 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 Engagements to Compile Financial Statements 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, Beta & Partners (‘B&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) A Limited (‘A’) is listed on the Stock Exchange of Hong Kong Limited. 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.

(b) The German holding company of B Limited (‘B’) requires all of its subsidiaries to prepare a special six-month interim financial statements. However, B has insufficient accounting resources to prepare the financial statements and requests B&P to do it for them.

(c) The firms 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 B&P and request B&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. B&P is asked by D to verify and to issue such a sales certificate.

(e) The New York Office of B&P has sent referral instructions to B&P to attend an inventory count on E Limited (‘E’). E is 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 B&P perform the engagement.

(The answer is at the end of the chapter)
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.

It is important for professional accountants to adhere to professional standards and guidance, as they serve the public interest and public confidence in the quality and reliability of financial reporting can contribute to the efficient functioning of the economy.

An audit provides assurance to the shareholders and other stakeholders of an entity on the financial statements because it is independent and impartial.

Assurance services include a range of assignments, from external audits to review engagements.

The auditors' report on entity financial statements is expressed in terms of truth and fairness.

External audits give reasonable assurance that the financial statements are free from material misstatement.

The degree of assurance given by the impartial professional accountant will depend on the nature of the exercise being carried out.

A review engagement is to enable a professional accountant to state whether anything has come to the professional accountant's attention that causes the professional accountant to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

No assurance is given for compilation or agreed-upon procedures engagements.
Answer to self-test question

Answer 1

(a) 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 A 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. B&P should follow HKSQC 1 (Clarified) Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements, Hong Kong Framework for Assurance Engagements and HKSRE 2400 Engagements to Review Financial Statements.

(b) The preparation of interim financial statements is not an assurance engagement. B&P should follow HKSQC 1 (Clarified) and HKSRS 4410 Engagements to Compile 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 criteria is the relevant accounting standards, which may be International Accounting Standards or Hong Kong Accounting Standards. B&P should follow HKSQC 1 (Clarified), Hong Kong Framework for Assurance Engagements and HKSRE 2410 Review of Interim Financial Information.

(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 turnover during the period under consideration. An agreed-upon procedures engagement is not an assurance engagement. B&P should follow HKSQC 1 (Clarified) and HKSRS 4400 Engagements to Perform Agreed-Upon 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 B&P's office in New York, it is not an audit engagement for the purpose of B&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. B&P should also follow HKSQC 1 (Clarified) and HKSRS 4400 Engagements to Perform Agreed-Upon Procedures Regarding Financial Information.
Noble Co

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 Jar Co should benefit from an audit of the company's financial statements by a firm of Public Certified 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 learnt in various practical cases.
chapter 6
Quality control

Topic list
1 Principles and purpose
2 Quality control at a firm level
3 Quality control on an individual audit

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 control quality and how they can be applied at firm and individual audit level.
In this chapter you will cover the following learning outcomes:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>2.06 Quality control considerations</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.06.01</td>
<td>Explain the principles and purposes of quality control of audit and other assurance engagements</td>
<td></td>
</tr>
<tr>
<td>2.06.02</td>
<td>Identify the features of a system of quality control relevant to a specific firm</td>
<td></td>
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<tr>
<td>2.06.03</td>
<td>Choose and explain quality control procedures that are relevant to a specific audit engagement</td>
<td></td>
</tr>
<tr>
<td>2.06.04</td>
<td>Assess and explain whether an engagement has been performed in line with professional standards and whether reports issued are appropriate</td>
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</table>
1 Principles and purpose

Audit quality is not defined in law or through regulations, nor do auditing standards provide a simple definition. However, 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, regulatory and legal requirements.

The fact that professional accountants follow accepted auditing standards (such as HKSAs) provides a general quality control framework within which audits should be conducted. There are also specific quality control standards.

2.1 Purpose of HKSQC 1 (Clarified)

**Purposes**

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

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 high standard audit work. HKSQC 1 (Clarified) states that professional accountants should ensure sufficient appropriate audit evidence is obtained in order to express the auditors’ opinion. 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.
The quality control standard addresses the issues relating to the following areas:

- Leadership responsibilities for quality within the firm
- Relevant ethical requirements
- Acceptance and continuous 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

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 Human resources

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 regulatory and legal 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.
2.4 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.

2.5 Engagement performance

The firm should 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 Consultation

The firm should 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 and scope of such consultations are documented
(d) conclusions resulting from consultations are documented and 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.
2.7 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 programs, 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.

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.

<table>
<thead>
<tr>
<th>Quality control reviews</th>
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<tbody>
<tr>
<td><strong>Nature, timing and extent</strong></td>
</tr>
<tr>
<td><strong>Eligibility</strong></td>
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<tr>
<td><strong>Documentation</strong></td>
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</table>
| **Listed entities** | The review should include all the following:  
  - The engagement team's evaluation of the firm's independence in relation to the specific engagement  
  - Significant risks identified during the engagement and the responses to those risks  
  - Judgments made, particularly with respect to materiality and significant risks  
  - 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  
  - The significance and disposition of corrected and uncorrected misstatements identified during the engagement |
Quality control reviews

Listed entities
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached
- The appropriateness of the report to be issued

2.8 Monitoring

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, and
- Comply with professional standards

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:

<table>
<thead>
<tr>
<th><strong>Ongoing evaluation of the system of quality control</strong></th>
<th><strong>An ongoing evaluation might include such questions as, ‘has it kept up to date with regulatory requirements’?</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Periodic inspection of a sample of completed engagements</strong></td>
<td><strong>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.</strong></td>
</tr>
</tbody>
</table>

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
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 set 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.

Engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with sufficient and relevant information to enable the firm's implementation of quality control system relating to independence.

3.1 Leadership responsibilities

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 should 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.

3.2 Ethical requirements

The engagement partner should consider whether members of the engagement team have complied with ethical requirements.

By ethical requirements the standard refers to the HKICPA Code of Ethics, which you studied in Chapter 3.

The HKSA also contains some detailed guidance about independence in particular.

**HKSA 220 (Clarified)**

The engagement partner should form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner should:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(b) 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;
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

The partner is required to ensure that the requirements of HKSQC 1 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.

### 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

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 holds a meeting with the audit 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)
- 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 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 (Clarified) – 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

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 1

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 it 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.
Audit quality is not defined in law or through regulations, nor do auditing standards provide a simple definition.

In Hong Kong, it is the Hong Kong Standard on Quality Control (HKQC 1 (Clarified)) that ensures that the firm and its staff comply with professional standards, regulatory and legal requirements.

HKSA 220 (Clarified) requires firms to implement quality control procedures over individual audit engagements.
Answer 1

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).
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 some 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>$’000</th>
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</thead>
<tbody>
<tr>
<td>Raw materials</td>
<td>8,800</td>
</tr>
<tr>
<td>Work in progress</td>
<td>13,290</td>
</tr>
<tr>
<td>Finished goods</td>
<td>20,730</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>42,820</strong></td>
</tr>
</tbody>
</table>

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 herbs experts to ensure compliance with quality standards.
(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

(b) Determine whether the familiarity threat has been properly addressed in this audit engagement.

(Total = 8 marks)

HKICPA May 2005 (amended)
chapter 7

Changes in auditor appointment

Topic list
1 Reasons for change of auditors
2 Appointment of auditors
3 Client acceptance procedures
4 Engagement letters
5 Books and documents

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.
In this chapter you will cover the following learning outcomes:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>2.03</th>
<th>Client and engagement acceptance procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.03.01</td>
<td></td>
<td>Explain the reasons why entities change their auditors / professional accountants</td>
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<tr>
<td>2.03.02</td>
<td></td>
<td>Explain the requirements relating to the appointment of auditors under the Hong Kong Companies Ordinance</td>
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<tr>
<td>2.03.03</td>
<td></td>
<td>Explain the procedures for a change of auditors</td>
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<tr>
<td>2.03.04</td>
<td></td>
<td>Explain the rights of the auditors in the process of a change of auditors</td>
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<tr>
<td>2.03.05</td>
<td></td>
<td>Explain the professional clearance procedures</td>
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<tr>
<td>2.03.06</td>
<td></td>
<td>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:</td>
</tr>
<tr>
<td>2.03.06.01</td>
<td></td>
<td>Client acceptance</td>
</tr>
<tr>
<td>2.03.06.02</td>
<td></td>
<td>Engagement acceptance</td>
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<td>2.03.06.03</td>
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<td>Agreement of the terms of engagement</td>
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<td>2.03.07</td>
<td></td>
<td>Identify the issues relating to the agreement of the scope and terms of an engagement with a client</td>
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<tr>
<td>2.03.08</td>
<td></td>
<td>Explain the procedures for the transfer of books, papers and information following a new appointment</td>
</tr>
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</table>
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 reasons 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
The directors should appoint an auditor within three months of incorporation and the appointed auditor shall hold office until the conclusion of the first Annual General Meeting (AGM) (S 131(3) Hong Kong Companies Ordinance).

Auditors should be appointed/re-appointed at each AGM and hold office until the conclusion of the next AGM (S 131(1) Hong Kong Companies Ordinance).
The directors may appoint auditors to fill a casual vacancy (e.g., in the event of death of the auditor) (S 131(5) Hong Kong Companies Ordinance).

Before accepting appointment the auditor should ensure that he is not disqualified from acting. He needs to be an approved company auditor which means he must hold a practising license 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 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 present fair the entity’s affairs at the end of the period and the statement of 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.

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. Auditors are entitled to attend any general meeting of the client and receive notice that the meeting is concerned with the auditor.

2.4 Outgoing auditors

2.4.1 Retiring auditor or auditor proposed to be removed

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
- 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

Code of Ethics – Code 440 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 done 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

Code of Ethics – Code 441 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

Your firm, AB & Partners ('AB'), has won the tender for an audit service to a new client, J Limited ('J').

J is not a listed client.

Required

Outline the legal and ethical requirements on the part of both AB and the last appointed auditor, YZ & Partners ('YZ') in respect of the change of auditors.

(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.

**HKSQC 1 (Clarified)**

The firm should establish policies and procedures for the acceptance and continuance of entity relationships and specific engagements designed to provide it 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 **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

HKSQC 1 (Clarified) gives a list of matters that the auditors might consider in relation to the acceptance decision.

<table>
<thead>
<tr>
<th>Matters to consider</th>
<th></th>
</tr>
</thead>
</table>
| 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 criminal activities
|                     | - The reasons for the proposed appointment of the firm and non-reappointment of the last appointed auditors |
# Matters to consider

## 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?
- What the future plans of the entity are, for example:
  - Is it planning to float its shares on an exchange in the near future?
  - Is growth, or diversification anticipated?

In addition, the firm needs to consider whether acceptance would create any conflicts of interest.

## HKSQC1 (Clarified)
Where the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the entity relationship should 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 should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented.

When 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 should 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 you should 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:
ACCEPT THE ENGAGEMENT?
HKSQC 1 (Clarified) – Firm wide
HKSA 220 (Clarified) – Specific engagement

CONSIDER:
- Ethical issues (the Code)
- Legal and technical barriers; and
- Management integrity

NEW CLIENT
EXISTING CLIENT

PROCEDURES:
- Ensure last appointed auditors’ removal or resignation have been properly conducted
- Special notice reviewed
- Obtain a copy of resolution passed
- Perform professional clearance
- Submit engagement letter
- Verify opening balances (HKSA 150 (Clarified)) (see Chapter 14)

PROCEDURES:
- Consider ability to serve
- Consider any significant change
- Consider change in management
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 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

4.2 When to send an engagement letter

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.

4.3 Contents of an engagement letter

The engagement letter should state the auditor 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:

(a) Objective of the financial statement audit
(b) Directors’ responsibilities – keeping proper accounting records, and making them available to the auditors
(c) 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
(d) Scope of auditor's work – ie applicable legislation, regulations and auditing standards, review accounting system, collection of audit evidence, and tests of internal controls
(e) Form of reports for the engagement
(f) 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

5 Books and documents

Topic highlights
Audit working papers belong to the auditor. Sometimes, the terms 'working papers' or 'work papers' are used.

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 HKSA 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
- the results of the audit procedures performed
- significant matters arising 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 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.

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.

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

- Common reasons behind entities changing their auditors include audit fee, auditor not seeking re-election and size of entity.
- The Hong Kong Companies Ordinance sets out the legalities associated with the appointment and removal of auditors.
- 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.
- HK SQC 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.
- Certain issues must be agreed in writing when an audit is accepted.
- Audit working papers belong to the auditor.
Answer 1

AB – incoming auditors

Legal requirements

AB should ensure it is not disqualified from appointment as the auditor of J Limited. For example, whether any partner of the firm is an employee or officer of J, its subsidiary or its holding company.

AB should find out whether the change of auditor has been properly dealt with in accordance with the Hong Kong Companies Ordinance or other legislation, for example, whether special notice of the resolution to appoint AB at a general meeting has been sent to the members of J.

Ethical requirements

AB should ensure that its staff have the necessary technical skills and professional competence to carry out the audit and should consider their independence.

AB should request J's permission to communicate with YZ. AB should decline nomination if J refuses permission for communication with YZ. AB should not accept nomination without first communicating in writing with YZ.

On receipt of permission to communicate with YZ, AB should enquire in writing of YZ if there are any unusual circumstances surrounding the proposed change which AB should be aware of. AB should give due weight to the reply of YZ and to any representations which YZ intends to make to the shareholders of J.

YZ – retiring auditors

Legal considerations

YZ has a right to make written representations to J with respect to the intended resolution to appoint AB as the auditor. YZ also has a right to request that the written representations to be sent to all members of J to whom a notice of the meeting was sent. If the representations have not been sent as requested, YZ are entitled to require that the representations be read at the general meeting.

As the auditor of J, YZ is entitled to attend any general meeting of J and to be heard at such a meeting on any part of the business of that meeting which concerns them as auditor. This right may appropriately be exercised by YZ even when they are retiring and will not be re-appointed.

Ethical considerations

On receipt of the written request from AB for professional clearance, YZ should act expeditiously. If there is no professional or other reason why AB should not accept nomination, YZ should reply accordingly without delay.

If YZ considers it appropriate to discuss J's affairs with AB, YZ should request permission of J to do so freely, if the permission is not granted, YZ should report that fact to AB.

On receipt of permission from J, YZ should advise AB of any concerns about the circumstances surrounding the proposed change and disclose fully all information needed by AB to enable its to decide whether to accept nomination.
Answer 2

(a) The following procedures should be carried out:

(i) Ensure that I and my audit 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.
The directors of Dragon Ltd are unhappy with the company's current auditor. They have been unable to persuade her to allow them to adopt a particular accounting policy. As a result, they want to replace her with a more compliant auditor.

Required
(a) Explain how statutory legislation should provide safeguards for the auditor against being removed from office. (12 marks)
(b) Discuss whether you think that these safeguards will be effective in practice. (3 marks)

(Total = 15 marks)
chapter 8
Planning, materiality and risk assessment

Topic list
1 Audit planning
2 Understanding the entity and its environment
3 Materiality
4 Risk
5 Risk assessment
6 Overall responses to assessed risk of material misstatement

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:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>2.05 Planning and risk assessment</th>
<th>2.05.01 Identify and explain:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The need for planning an audit</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The contents of the overall audit strategy and the audit plan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The relationship between the overall audit strategy and the audit plan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Develop and document an audit plan</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Explain how auditors obtain an initial understanding of the entity and its environment including the use of preliminary analytical review procedures</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Explain the components of audit risk</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assess the risk of material misstatement at the financial statement level and assertion level</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recognise and suggest overall responses to assessed risk</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Recognise and suggest specific procedures to respond to assessed risks</td>
<td></td>
</tr>
<tr>
<td>2.07</td>
<td>Documentation</td>
<td>3</td>
</tr>
<tr>
<td>2.07.01</td>
<td>Document an audit plan</td>
<td></td>
</tr>
<tr>
<td>2.08</td>
<td>Materiality</td>
<td>3</td>
</tr>
<tr>
<td>2.08.01</td>
<td>Define materiality and demonstrate how it should be applied in the context of financial reporting and auditing</td>
<td></td>
</tr>
</tbody>
</table>
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.

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 auditor shall plan the audit so that the engagement is performed in an effective manner.

HKSA 300 (Clarified) states that 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.

An auditor can achieve the following benefits from planning:

- Carry out a most effective and efficient audit
- Conduct the audit in a timely manner
- Achieve audit objectives
- Allocate appropriate team members and assignment of work
- Achieve better co-ordination
- Draw attention to high risk important areas
- Complete audit on a timely basis
- Respond appropriately to recent changes in industry regulations and financial reporting

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.
1.2 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.

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 (Clarified) – see below.

However, there are common elements to all strategies which are presented in the table that follows:

<table>
<thead>
<tr>
<th>The audit strategy: matters to consider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Characteristics of the engagement</td>
</tr>
<tr>
<td>• Relevant financial reporting framework</td>
</tr>
<tr>
<td>• Industry regulation</td>
</tr>
<tr>
<td>• Expected scope of audit</td>
</tr>
<tr>
<td>• Characteristics of business segments</td>
</tr>
<tr>
<td>• Availability of internal audit staff and work performed</td>
</tr>
<tr>
<td>• Use of service organisations</td>
</tr>
<tr>
<td>• Effect of information and communications technology on audit procedures</td>
</tr>
<tr>
<td>• Availability of entity staff and information</td>
</tr>
<tr>
<td>Reporting objectives, timing of the audit and nature of communications</td>
</tr>
<tr>
<td>• Entity’s timescale for reporting and accounting policies</td>
</tr>
<tr>
<td>• New accounting standards</td>
</tr>
<tr>
<td>• Organisation of meetings with management and those charged with governance</td>
</tr>
<tr>
<td>• Discussions with management and those charged with governance</td>
</tr>
<tr>
<td>• Expected communications with third parties</td>
</tr>
<tr>
<td>Significant factors, preliminary engagement activities, and knowledge gained on other engagements</td>
</tr>
<tr>
<td>• Determination of materiality</td>
</tr>
<tr>
<td>• Areas identified with higher risks of material misstatement</td>
</tr>
<tr>
<td>• Results of previous audits</td>
</tr>
<tr>
<td>• Need to maintain professional scepticism</td>
</tr>
<tr>
<td>• Evidence of management’s commitment to design, implementation and maintenance of sound internal controls</td>
</tr>
<tr>
<td>• Volume of transactions</td>
</tr>
<tr>
<td>• Significant business developments</td>
</tr>
<tr>
<td>• Significant industry developments and conditions</td>
</tr>
<tr>
<td>• Significant changes in financial reporting framework</td>
</tr>
<tr>
<td>• Other significant recent developments</td>
</tr>
<tr>
<td>• Any going concern issues</td>
</tr>
</tbody>
</table>
The audit strategy: matters to consider

**Nature, timing and extent of resources**
- Selection of engagement team
- Assignment of work to team members
- Engagement budget

**Key term**

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 programs or completion checklist 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.

### 1.3 Agreeing the terms of audit engagement

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 should:

(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 shall agree the terms of the audit engagement with management or those charged with governance. The agreed terms of the audit engagement 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.

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 (Clarified) Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment. 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:

<table>
<thead>
<tr>
<th>Obtaining an understanding of the entity and its environment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Why?</strong></td>
</tr>
<tr>
<td>• To identify and assess the risks of material misstatement in the financial statements whether due to fraud or error other factors</td>
</tr>
<tr>
<td>• To enable the auditor to design and perform further audit procedures</td>
</tr>
<tr>
<td>• To provide a frame of reference for exercising audit judgment, for example, when setting audit materiality and identifying special audit areas</td>
</tr>
<tr>
<td>• To evaluate sufficient and appropriate audit evidence</td>
</tr>
<tr>
<td>• To develop expectations for use when performing analytical procedures</td>
</tr>
<tr>
<td><strong>What?</strong></td>
</tr>
<tr>
<td>• Industry, regulatory and other external factors, including the applicable financial reporting framework</td>
</tr>
<tr>
<td>• Nature of the entity, including operations, ownership and governance, investments, structure and financing</td>
</tr>
<tr>
<td>• Entity’s selection and application of accounting policies</td>
</tr>
<tr>
<td>• Objectives and strategies and related business risks that might cause material misstatement in the financial statements</td>
</tr>
<tr>
<td>• Measurement and review of the entity’s financial performance</td>
</tr>
<tr>
<td>• Internal control</td>
</tr>
<tr>
<td><strong>How?</strong></td>
</tr>
<tr>
<td>• Inquiries of management and others within the entity (ie internal auditors or those charged with governance)</td>
</tr>
<tr>
<td>• Analytical procedures to highlight areas of high risk</td>
</tr>
<tr>
<td>• Observation and inspection of activities and operations of the entity</td>
</tr>
<tr>
<td>• Prior period knowledge</td>
</tr>
<tr>
<td>• Entity acceptance or continuance process</td>
</tr>
<tr>
<td>• Discussion by the audit team of the susceptibility of the financial statements to material misstatement and the application of the applicable financial reporting framework</td>
</tr>
<tr>
<td>• Information from other engagements undertaken for the entity</td>
</tr>
<tr>
<td>• Reconsider the nature, extent and timeliness of substantive testing</td>
</tr>
</tbody>
</table>

**Key term**

Analytical procedures consist of the evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. They also encompass the investigation of identified fluctuations and relationships that are consistent with other relevant information or deviate significantly from predicted amounts.
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 HKAS 1 (Revised) material 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 fact'.
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.

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 i.e., 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 – i.e., 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.

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 (Clarified) states that 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 profits 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**

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. 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**

Sometimes auditors have to set performance materiality for a particular class of transactions, account balance or disclosure. This is because planning the audit to detect material misstatements fails to take into account the aggregated affect of smaller misstatements on the overall financial statements. As for the determination of materiality at the financial statement level, there is no single formula for this and judgment must be used based on the auditor's understanding of the entity and identified risks.

The auditor is required to determine performance materiality for purposes of:

(a) Assessing the risks of material misstatement; and
(b) Determining the nature, timing and extent of further audit procedures

Performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeding materiality for the financial statements as a whole.

The determination of performance materiality involves the exercise of professional judgment and is affected by:

(i) the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and
(ii) the nature and extent of misstatements identified in previous audits and the auditor's expectations in relation to misstatements in the current period.

**Self-test question 1**

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 per cent 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:

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue $m</th>
<th>Operating Profit $m</th>
<th>Total assets $m</th>
<th>Net assets $m</th>
</tr>
</thead>
<tbody>
<tr>
<td>20Y0</td>
<td>1,324</td>
<td>56</td>
<td>1,555</td>
<td>755</td>
</tr>
<tr>
<td>20X9</td>
<td>1,266</td>
<td>72</td>
<td>1,494</td>
<td>685</td>
</tr>
<tr>
<td>20X8</td>
<td>1,275</td>
<td>90</td>
<td>1,617</td>
<td>615</td>
</tr>
<tr>
<td>20X7</td>
<td>1,512</td>
<td>78</td>
<td>1,387</td>
<td>580</td>
</tr>
<tr>
<td>20X6</td>
<td>1,739</td>
<td>67</td>
<td>1,629</td>
<td>605</td>
</tr>
</tbody>
</table>

**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.

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**:

![Audit Risk Model Diagram](image)

4.1.1 **Inherent risk**

**Key term**

**Inherent risk (IR)** is the susceptibility of an account balance or class of transactions to a misstatement that may be material either individually or when aggregated with other misstatements, based on the assumptions that there are no related internal controls.

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

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Integrity and risk profile of senior management</strong></td>
<td>Domination by a powerful individual may cause problems</td>
</tr>
<tr>
<td><strong>Management quality experience</strong></td>
<td>Changes in management and quality of financial management</td>
</tr>
<tr>
<td><strong>Aggressive targets put pressure of management</strong></td>
<td>Examples include tight reporting deadlines, or market or financing expectations</td>
</tr>
<tr>
<td><strong>Profile of product or service offering</strong></td>
<td>Potential problems include technological obsolescence or over-dependence on single product</td>
</tr>
<tr>
<td><strong>Industry environmental factors</strong></td>
<td>Competitive conditions, regulatory requirements, technological developments, sudden drop or rise in customer demand</td>
</tr>
<tr>
<td><strong>Information and communications technology</strong></td>
<td>Problems include lack of supporting documentation, concentration of expertise in key people, or unauthorised access</td>
</tr>
</tbody>
</table>

### Factors affecting individual account balances or transactions (assertion level)

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial statement accounts prone to misstatement</strong></td>
<td>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</td>
</tr>
<tr>
<td><strong>Complex accounts</strong></td>
<td>Accounts which require expert valuations or are subjects of current professional discussion may be considered complex</td>
</tr>
<tr>
<td><strong>Assets at risk of being lost or pilfered</strong></td>
<td>Cash, inventory, portable non-current assets (such as lap top computers)</td>
</tr>
<tr>
<td><strong>Quality of accounting systems</strong></td>
<td>This depends on the controls over and competence and efficiency of individual departments (sales, purchases, cash etc)</td>
</tr>
<tr>
<td><strong>High volume transactions</strong></td>
<td>The accounting system may have problems coping with sudden peaks in demand</td>
</tr>
</tbody>
</table>

### Factors affecting individual account balances or transactions

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unusual transactions</strong></td>
<td>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)</td>
</tr>
<tr>
<td></td>
<td>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</td>
</tr>
<tr>
<td><strong>Staff</strong></td>
<td>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</td>
</tr>
</tbody>
</table>

### 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 material misstatement that could occur in an assertion and that could be material, 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.
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. Controls testing will be examined in more detail in Chapter 11.

### 4.1.3 Detection risk

**Key term**

Detection risk (DR) is the risk that the auditors’ procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements.

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 components of detection risk, 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 entity through being in operation.

**Key terms**

**Business risk** is the risk inherent to the entity in its operations. It is risks at all levels of the business. 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 materialize, 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 assess the risks of material misstatement in the financial statements, also identifying significant risks.

#### 5.1 Identifying and assessing the risks of material misstatement

HKSA 315 (Clarified) 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

**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 the controls are implemented to mitigate these risks.

Auditors should evaluate the design of 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 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 (Clarified), 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:

<table>
<thead>
<tr>
<th>Differences between financial statement level and assertion level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>At the financial statement level</strong></td>
</tr>
<tr>
<td>✔ Applying to the financial statements as a whole</td>
</tr>
<tr>
<td>✔ Able to reduce audit risk to an acceptably low level</td>
</tr>
<tr>
<td>✔ More pervasive to the financial statements at a whole</td>
</tr>
<tr>
<td>✔ Affect many assertions</td>
</tr>
<tr>
<td>✔ Risks from a deficient control environment which includes management's attitudes towards good internal control practice</td>
</tr>
<tr>
<td>✔ Deficiencies in controls, in particular of management's lack of competence</td>
</tr>
<tr>
<td>✔ Aggressive business strategies</td>
</tr>
<tr>
<td>✔ Significant business risk: such as fraud</td>
</tr>
<tr>
<td>✔ Complexity of business operation</td>
</tr>
<tr>
<td>✔ High pressure on performance measures and reviews</td>
</tr>
<tr>
<td>✔ Cannot focus on a specific risk</td>
</tr>
<tr>
<td>✔ Concern about the entity as a going concern</td>
</tr>
<tr>
<td><strong>At the assertion level</strong></td>
</tr>
<tr>
<td>✔ Not able to reduce the risks of material misstatement to an acceptably low level with audit evidence obtained only from substantive procedures</td>
</tr>
<tr>
<td>✔ Refer to specific classes of transactions, accounts balances</td>
</tr>
<tr>
<td>✔ Risks arise from the particular characteristics of a class of transaction</td>
</tr>
<tr>
<td>✔ Identify controls that are likely to prevent, detect or correct material misstatements</td>
</tr>
<tr>
<td>✔ Comprises of inherent risk and control risk (Combined assessment of the risk of material misstatement)</td>
</tr>
<tr>
<td>✔ Auditor would perform tests of controls to support the risk assessment</td>
</tr>
</tbody>
</table>
### Differences between financial statement level and assertion level

**Factors to consider**
- Management integrity
- Management experience and knowledge
- Unusual pressures on management (e.g., plan to go public, bonuses tied to sales or profits)
- Nature of entity's business
- Industry factors (e.g., special regulations and reporting changes)

**Factors to consider**
- Accounts likely to be susceptible to misstatements (e.g., required many adjustments in previous year's audit or accounts that include estimated amounts)
- Complexity of underlying transactions (e.g., financial instruments)
- Degree of judgment involved in determining account balances (e.g., 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 (e.g., 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.

Significant risks are often related to:
- non-routine transactions
- judgmental matters

### 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 2
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

6.1 Overall responses to risks of material misstatement at financial statement level

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 audit 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.

<table>
<thead>
<tr>
<th>Risk at financial statement level is low</th>
<th>No specific additional response</th>
<th>Maintain professional scepticism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk at financial statement level is normal to medium</td>
<td>Remind the engagement to maintain professional scepticism</td>
<td>Assign more experienced staff</td>
</tr>
<tr>
<td>Risk at financial statement level is high</td>
<td>Remind the engagement to maintain professional scepticism</td>
<td>Assign more experienced staff</td>
</tr>
</tbody>
</table>

6.2 Overall responses to risks of material misstatements at assertion level

The HKSA 330 (Clarified) says that the auditor shall design and perform appropriate 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
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

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. The 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.
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.

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.

The audit strategy and audit plan shall be updated and changed as necessary during the course of the audit.

**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.

**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 risks of material misstatement (**inherent risk** and **control risk**) and the risk that the auditors will not detect such misstatement (**detection risk**).

When the auditor has obtained an understanding of the entity, he shall assess the risks of material misstatement in the financial statements, also identifying significant risks.

**Significant risks** are complex or unusual transactions, those that may indicate fraud, or other special risks.

Business risk is the risk arising to companies through being in operation.

Auditors must ensure they have **documented** the work done at the risk assessment stage, such as the discussion among the audit team of the susceptibility of the financial statements to material misstatements, significant risks, and overall responses.
Answer 1

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.

<table>
<thead>
<tr>
<th>Some commonly accepted bases</th>
<th>Typical % ranges</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit</td>
<td>5–10% HK$2.8m – 5.6m</td>
<td>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.</td>
</tr>
<tr>
<td>Revenue</td>
<td>0.5–1.0% HK$6.6m – 13.2m</td>
<td>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.</td>
</tr>
<tr>
<td>Total assets</td>
<td>0.5–1.0% HK$7.8m – 15.6m</td>
<td>Over the last two years, the total assets were around 20 per cent more than the annual turnover, 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.</td>
</tr>
<tr>
<td>Equity (net assets)</td>
<td>1.0–2.0% HK$7.6m – 15.1m</td>
<td>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.</td>
</tr>
</tbody>
</table>
Answer 2

Risks

HKSA 315 (Clarified) states that audit risk is the product of inherent risk, 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

Complex Limited

You are the manager in charge of the audit of the financial statements of Complex Limited ("Complex") for the year ended 31 December 20X4. Complex is engaged in the trading of computers in Hong Kong. You understand that during the last year, computer traders were cutting prices to retain their market position or simply to survive. The management of Complex has provided you with the following information extracted from the management accounts for the year ended 31 December 20X4:

<table>
<thead>
<tr>
<th>20X4</th>
<th>20X3</th>
<th>Increase/Decrease</th>
<th>Increase/Decrease %</th>
</tr>
</thead>
<tbody>
<tr>
<td>$000</td>
<td>$000</td>
<td>$000</td>
<td>%</td>
</tr>
</tbody>
</table>

Income statement

<table>
<thead>
<tr>
<th></th>
<th>20X4</th>
<th>20X3</th>
<th>Increase/Decrease</th>
<th>Increase/Decrease %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>800,000</td>
<td>700,000</td>
<td>100,000</td>
<td>14.3</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(720,000)</td>
<td>(600,000)</td>
<td>120,000</td>
<td>20.0</td>
</tr>
<tr>
<td>Gross profit</td>
<td>80,000</td>
<td>100,000</td>
<td>(20,000)</td>
<td>(20.0)</td>
</tr>
<tr>
<td>Selling and distribution costs</td>
<td>(20,000)</td>
<td>(18,000)</td>
<td>2,000</td>
<td>11.1</td>
</tr>
<tr>
<td>General and administration expenses</td>
<td>(10,000)</td>
<td>(9,000)</td>
<td>1,000</td>
<td>11.1</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>50,000</td>
<td>73,000</td>
<td>(23,000)</td>
<td>(31.5)</td>
</tr>
<tr>
<td>Taxation</td>
<td>(3,000)</td>
<td>(13,000)</td>
<td>(10,000)</td>
<td>(76.9)</td>
</tr>
<tr>
<td>Net profit</td>
<td>47,000</td>
<td>60,000</td>
<td>(13,000)</td>
<td>(21.7)</td>
</tr>
</tbody>
</table>

Analysis of cost of sales:

<table>
<thead>
<tr>
<th></th>
<th>20X4</th>
<th>20X3</th>
<th>Increase/Decrease</th>
<th>Increase/Decrease %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening inventories</td>
<td>20,000</td>
<td>10,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>780,000</td>
<td>610,000</td>
<td>170,000</td>
<td></td>
</tr>
<tr>
<td>Less: Closing inventories</td>
<td>80,000</td>
<td>20,000</td>
<td>60,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>720,000</td>
<td>600,000</td>
<td>120,000</td>
<td></td>
</tr>
</tbody>
</table>

Statement of financial position at December 31

<table>
<thead>
<tr>
<th></th>
<th>20X4</th>
<th>20X3</th>
<th>Increase/Decrease</th>
<th>Increase/Decrease %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>40,000</td>
<td>100,000</td>
<td>(60,000)</td>
<td>(60.0)</td>
</tr>
<tr>
<td>Inventories</td>
<td>80,000</td>
<td>20,000</td>
<td>60,000</td>
<td>300.0</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>150,000</td>
<td>60,000</td>
<td>90,000</td>
<td>150.0</td>
</tr>
<tr>
<td>Trade payables</td>
<td>(150,000)</td>
<td>(70,000)</td>
<td>80,000</td>
<td>114.3</td>
</tr>
<tr>
<td>Bank borrowings</td>
<td>(100,000)</td>
<td>(40,000)</td>
<td>60,000</td>
<td>150.0</td>
</tr>
<tr>
<td></td>
<td>20,000</td>
<td>70,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Non-current assets and liabilities are not material.

<table>
<thead>
<tr>
<th></th>
<th>20X4</th>
<th>20X3</th>
<th>Increase</th>
<th>Increase %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other non-financial data</td>
<td></td>
<td></td>
<td>30,000</td>
<td>60.0</td>
</tr>
<tr>
<td>Number of units sold</td>
<td>80,000</td>
<td>50,000</td>
<td>30,000</td>
<td>60.0</td>
</tr>
</tbody>
</table>

Required

Assess the risks of material misstatements at the assertion level for:

(a) the class of transactions in the draft income statement; and
(b) the account balances in the draft statement of financial position.

Consider any other matters when you develop the overall audit plan based on the above information.

HKICPA May 2005 (amended)

(15 marks)
chapter 9

Audit evidence, procedures, audit methodologies and audit sampling

Topic list
1 Audit evidence
2 Financial statement assertions
3 Audit methodologies
4 Audit sampling
5 Audit documentation

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:

<table>
<thead>
<tr>
<th>2.04</th>
<th>Audit methodologies</th>
<th>Competency level</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.04.01</td>
<td>Describe the key features of the following audit methodologies:</td>
<td>3</td>
</tr>
<tr>
<td>2.04.01.01</td>
<td>Risk-based auditing</td>
<td></td>
</tr>
<tr>
<td>2.04.01.02</td>
<td>Top-down auditing</td>
<td></td>
</tr>
<tr>
<td>2.04.01.03</td>
<td>System-based auditing</td>
<td></td>
</tr>
<tr>
<td>2.04.01.04</td>
<td>Systems audit</td>
<td></td>
</tr>
<tr>
<td>2.04.01.05</td>
<td>Balance sheet approach</td>
<td></td>
</tr>
<tr>
<td>2.04.01.06</td>
<td>Transaction cycle approach</td>
<td></td>
</tr>
<tr>
<td>2.04.01.07</td>
<td>Directional testing</td>
<td></td>
</tr>
<tr>
<td>2.04.02</td>
<td>Understand the cost and performance efficiency of different audit methodologies</td>
<td>2</td>
</tr>
<tr>
<td>2.07</td>
<td>Documentation</td>
<td>3</td>
</tr>
<tr>
<td>2.07.02</td>
<td>Explain the need for and the importance of audit documentation</td>
<td></td>
</tr>
<tr>
<td>2.09</td>
<td>Audit procedures</td>
<td>3</td>
</tr>
<tr>
<td>2.09.01</td>
<td>Define audit sampling</td>
<td></td>
</tr>
<tr>
<td>2.09.02</td>
<td>Explain the need for sampling</td>
<td></td>
</tr>
<tr>
<td>2.09.03</td>
<td>Apply the basic principles of sampling</td>
<td></td>
</tr>
<tr>
<td>2.09.04</td>
<td>Assess and explain the results of sampling</td>
<td></td>
</tr>
<tr>
<td>2.10</td>
<td>Audit evidence</td>
<td>3</td>
</tr>
<tr>
<td>2.10.01</td>
<td>Explain the procedures by which audit evidence may be obtained</td>
<td></td>
</tr>
<tr>
<td>2.10.02</td>
<td>Assess the appropriate and sufficiency (relevance and reliability) of different sources of audit evidence</td>
<td></td>
</tr>
<tr>
<td>2.10.03</td>
<td>Explain the assertions contained in the financial statements and their use in obtaining evidence</td>
<td></td>
</tr>
</tbody>
</table>
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
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
Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the audit opinion is based.

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:
(a) obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion;
(b) ascertain the accuracy and completeness of the evidence; and
(c) 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 (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
- Sufficiency is the measure of the quantity of audit evidence.
- Appropriateness is the measure of the quality or 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 Relevancy and reliability of audit evidence

**Relevancy** 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.

<table>
<thead>
<tr>
<th>Source</th>
<th>Quality of evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>External</td>
<td>Audit evidence from <strong>external sources</strong> is more reliable than that obtained from the entity's records because it is from an <strong>independent</strong> source</td>
</tr>
<tr>
<td>Auditor</td>
<td>Evidence obtained <strong>directly by auditors</strong> is more reliable than that obtained indirectly or by inference</td>
</tr>
<tr>
<td>Entity</td>
<td>Evidence obtained from the entity's records is more reliable when the related control system operates effectively</td>
</tr>
<tr>
<td>Written</td>
<td>Evidence in the form of <strong>documents (paper or electronic)</strong> or <strong>written representations</strong> are more reliable than oral representations, since oral representations can be retracted</td>
</tr>
<tr>
<td>Originals</td>
<td><strong>Original documents</strong> are more reliable than photocopies or facsimiles, which can easily be altered by the entity</td>
</tr>
</tbody>
</table>

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 and limitations. 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:

(a) **Internal sources** of audit evidence include: accounting records, management reports and documents, internal control, assets, management and other employees.

(b) **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 tests 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**

**Financial statement assertions** are the set of information that management of an entity provides its auditors as the financial statements. Closely interrelated, as used by the auditor must use their judgment and experience to consider the different types of potential misstatements that may occur.

The auditor will carry out procedures that are designed to test the financial statement assertions.

<table>
<thead>
<tr>
<th>Assertions used by the auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assertions about <strong>classes of transactions and events</strong> for the period under audit</td>
</tr>
<tr>
<td><strong>Occurrence</strong>: transactions and events that have been recorded have occurred and pertain to the entity</td>
</tr>
<tr>
<td><strong>Completeness</strong>: all transactions and events that should have been recorded have been recorded</td>
</tr>
<tr>
<td><strong>Accuracy</strong>: amounts and other data relating to recorded transactions and events have been recorded appropriately</td>
</tr>
<tr>
<td><strong>Cut-off</strong>: transactions and events have been recorded in the correct accounting period</td>
</tr>
<tr>
<td><strong>Classification</strong>: transactions and events have been recorded in the proper financial statements</td>
</tr>
</tbody>
</table>
Assertions used by the auditor

<table>
<thead>
<tr>
<th>Assertions about account balances at the period-end</th>
<th>Existence: assets, liabilities, and equity interests exist</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rights and obligations: the entity holds or controls the rights to assets, and liabilities are the obligations of the entity</td>
<td></td>
</tr>
<tr>
<td>Completeness: all assets, liabilities and equity interests that should have been recorded have been recorded</td>
<td></td>
</tr>
<tr>
<td>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</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assertions about presentation and disclosure</th>
<th>Occurrence and rights and obligations: disclosed events, transactions and other matters have occurred and pertain to the entity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completeness: all disclosures that should have been included in the financial statements have been included</td>
<td></td>
</tr>
<tr>
<td>Classification and understandability: financial information is appropriately presented and described, and disclosures are clearly expressed</td>
<td></td>
</tr>
<tr>
<td>Accuracy and valuation: financial and other information are disclosed fairly and at appropriate amounts</td>
<td></td>
</tr>
</tbody>
</table>

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.

The auditor obtains audit evidence by undertaking audit procedures to do the following:

(a) Obtain an understanding of the entity and its environment to assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels (risk assessment procedures)

(b) Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level (tests of controls)

(c) 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.

Key terms
Tests of controls are performed to obtain audit evidence about the operating effectiveness of controls preventing, or detecting and correcting, material misstatements at the assertion level.
Substantive procedures are audit procedures performed 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.

<table>
<thead>
<tr>
<th>Procedures</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inspection of tangible assets</td>
<td>Inspection of tangible assets that are recorded in the accounting records confirms existence, but does not necessarily confirm rights and obligations or valuation. Confirmation that assets seen are recorded in accounting records gives evidence of completeness.</td>
</tr>
<tr>
<td>Inspection of documentation or records</td>
<td>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). Inspection can provide evidence of existence (e.g., 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.</td>
</tr>
<tr>
<td>Observation</td>
<td>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.</td>
</tr>
<tr>
<td>Inquiry</td>
<td>This involves seeking information from entity staff or external sources. 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.</td>
</tr>
<tr>
<td>Confirmation</td>
<td>This is the process of obtaining a representation of information or of an existing condition directly from a third party e.g., confirmation from bank of bank balances. Confirmations are used to obtain audit evidence about the absence of certain conditions.</td>
</tr>
<tr>
<td>Recalculation</td>
<td>This consists of checking the mathematical accuracy of documents or records and can be performed through the use of IT.</td>
</tr>
<tr>
<td>Reperformance</td>
<td>This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>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.</td>
</tr>
</tbody>
</table>
Self-test question 1

(a) Describe the general considerations which auditors must bear in mind when evaluating audit evidence.

(b) Discuss the quality of the following types of audit evidence, giving examples of each form of evidence:

(i) Evidence originated by the auditors;

(ii) Evidence composed by external parties; and

(iii) Evidence composed by the client's management.

(The answer is at the end of the chapter)

3 Audit methodologies

3.1 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 errors 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.

3.2 '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 (Clarified) (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 at the 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:

<table>
<thead>
<tr>
<th>Audit procedure</th>
<th>Effect of 'top-down' approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tests of controls</td>
<td>Controls testing is focused on the control environment and corporate governance rather than the detailed procedural controls tested under traditional approaches</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>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</td>
</tr>
<tr>
<td>Detailed testing</td>
<td>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</td>
</tr>
</tbody>
</table>

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.

3.2.1 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 error 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
3.3 Systems audit versus system-based audit

3.3.1 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 assessed 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:

<table>
<thead>
<tr>
<th>Factors</th>
<th>Questions asked</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Management policy</strong></td>
<td>• Does management have a written statement of policy with regard to computer systems?</td>
</tr>
<tr>
<td></td>
<td>• Is it compatible with management policy in other areas?</td>
</tr>
<tr>
<td></td>
<td>• Is it adhered to?</td>
</tr>
<tr>
<td></td>
<td>• Are the policies sufficient and effective?</td>
</tr>
<tr>
<td></td>
<td>• Is it updated when the systems are updated?</td>
</tr>
<tr>
<td></td>
<td>• Does it relate to the current system?</td>
</tr>
<tr>
<td><strong>Segregation of duties</strong></td>
<td>• Is there adequate segregation with regard to data input?</td>
</tr>
<tr>
<td></td>
<td>• Are there adequate system controls (eg passwords) to enforce segregation of duties?</td>
</tr>
<tr>
<td><strong>Security</strong></td>
<td>• 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</td>
</tr>
<tr>
<td></td>
<td>• Is it adhered to?</td>
</tr>
<tr>
<td></td>
<td>• Is it sufficient and effective?</td>
</tr>
</tbody>
</table>

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.

3.3.2 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.

### 3.4 Balance sheet approach

**Topic highlights**
An auditor may choose predominantly to carry out substantive tests on year end balances.

#### 3.4.1 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.

#### 3.4.2 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.

#### 3.4.3 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.

### 3.5 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 comprehensive income (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.
3.6 Directional testing

Topic highlights
Directional testing is a method of discovering errors and omissions in financial statements.

Directional testing is a method of undertaking detailed substantive testing. Substantive testing seeks to discover errors 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 errors (resulting in over or understatement)
- Tests to discover omissions (resulting in understatement)

3.6.1 Tests designed to discover errors
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.

3.6.2 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.

3.6.3 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).

3.7 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 per cent substantive procedures, it is not possible to carry out a 100 per cent 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:

3.7.1 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.

3.7.2 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.

3.7.3 Systems audit

A system audit concentrates on testing the contract 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.
3.7.4 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.

3.7.5 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.

4 Audit sampling

**Topic highlights**

Auditors usually seek evidence from less than 100 per cent of items of the balance or transaction being tested by using **sampling techniques**.

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 per cent** 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 per cent of items when carrying out tests of controls, but 100 per cent testing may be appropriate for certain substantive procedures. 100 per cent 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 per cent examination may be appropriate; or

(iii) The repetitive nature of a calculation or other process **performed automatically by an information system** makes a 100 per cent 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.

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### 4.1 Introduction to audit sampling

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 and Other Means of Testing* states that 'when designing audit procedures, the auditor should determine appropriate means for selecting items for testing so as to gather sufficient appropriate audit evidence to meet the objectives of audit procedures'.

---

**Key terms**

**Audit sampling** involves the application of audit procedures to less than 100 per cent of the items within an account balance or class of transactions such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the entire population. Audit sampling can be applied using either a statistical or non-statistical approach.

**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.

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### 4.2 Design of the sample

**4.2.1 Suitable for the purpose**

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 and what population to use for sampling.

Key terms

Error means either control deviations, when performing tests of control, or misstatements, when performing substantive procedures.

Expected error is the error that the auditor expects to be present in the population.

(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 per cent 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 is 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 achieve the particular audit objectives.

Key term

Sampling units are the individual items constituting a population.

The HKSA requires that the auditor ‘should select items for the sample with the expectation that all sampling units in the population have a chance of selection’. This requires that all items in the population have an opportunity of being selected.

There are five selection methods available:

<table>
<thead>
<tr>
<th>Method</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Random selection</td>
<td>Ensures that all items in the population have an equal chance of selection, eg by use of random number tables or computerised generator.</td>
</tr>
<tr>
<td>Systematic selection</td>
<td>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.</td>
</tr>
<tr>
<td>Haphazard selection</td>
<td>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.</td>
</tr>
</tbody>
</table>
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.

Stratification is the process of dividing a population into subpopulations, each of which is 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 error. Ways of dividing items into strata include by age or by amount.

4.3 Sample size and risk

While inevitable and beneficial in many ways, the use of sampling introduces an element of sampling risk. This is the risk 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

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

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to 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 and fail to recognise a misstatement or deviation.

Sampling risk can lead to two types of erroneous conclusions:

**Tests of controls**
- Controls are more effective than they actually are (1)
- Controls are less effective that they actually are (2)

**Tests of details**
- 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 types 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.

### 4.4 Performing audit procedures on items selected

HKSA 530 (Clarified) requires that the auditor shall perform audit procedures, appropriate to the purpose, on each item selected. If the audit procedures 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 the prescribed control in the case of tests of controls; or misstatement in the case of tests of details.

### 4.5 Deviation or misstatements

Based on the sampling results, HKSA 530 (Clarified) requires the auditor to:

(a) investigate the nature and cause of any deviation or misstatements identified; and

(b) 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 any may indicate the possibility of fraud.

#### 4.5.2 Anomaly

**Key term**

**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.

### 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 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 errors in the sample

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.

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 auditor 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 errors

For tests of details, the auditor should project monetary errors found in the sample to the population, and should consider the effect of the projected error on the audit objective being tested and on other areas of the audit. The projected error should be compared to the tolerable error.

Self-test question 2

Consider each of the following independent situations:

(a) The auditor used 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 five per cent risk of over reliance, a tolerable deviation rate of 10 per cent 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.
5 Audit documentation

5.1 Requirement of audit documentation

Key term
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.

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 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

The 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
An experienced auditor refers to an individual who has practical audit experience and a reasonable understanding of the audit processes, accounting and legal requirements, the business environment 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 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 identified risks of material misstatement;  
(c) the significance of the audit evidence obtained;  
(d) the nature and extent of exceptions identified;  
(e) 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  
(f) the audit methodology and tools used.  

### 5.1.2 Examples of working papers

<table>
<thead>
<tr>
<th>Work at different stages in audit</th>
<th>Information to be put in working file</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit planning</td>
<td>Evidence of the planning process including audit programmes and any changes thereto</td>
</tr>
<tr>
<td>Understanding the entity and its environment</td>
<td>Information obtained in understanding the entity and its environment, including its internal control, such as the following:</td>
</tr>
<tr>
<td></td>
<td>• Information concerning the legal documents, agreements and minutes</td>
</tr>
<tr>
<td></td>
<td>• Extracts or copies of important legal documents, agreements and minutes</td>
</tr>
<tr>
<td></td>
<td>• Information concerning the industry, economic environment and legislative environment within which the entity operates</td>
</tr>
<tr>
<td></td>
<td>• Extracts from the entity’s internal control manual</td>
</tr>
<tr>
<td>Evidence gathering</td>
<td>• Analyses of transactions and balances</td>
</tr>
<tr>
<td></td>
<td>• Analyses of significant ratios and trends</td>
</tr>
<tr>
<td></td>
<td>• Identified and assessed risks of material misstatements</td>
</tr>
<tr>
<td></td>
<td>• A record of the nature, timing, extent and results of audit procedures</td>
</tr>
<tr>
<td></td>
<td>• Evidence that the work performed was supervised and reviewed</td>
</tr>
<tr>
<td></td>
<td>• An indication as to who performed the audit procedures and when they were performed</td>
</tr>
</tbody>
</table>
## 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 relate to the current reporting period only.
<table>
<thead>
<tr>
<th>Audit files: working papers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Permanent audit files</strong> (containing information of <strong>continuing importance</strong> to the audit)</td>
</tr>
<tr>
<td>• Engagement letters</td>
</tr>
<tr>
<td>• New client questionnaire</td>
</tr>
<tr>
<td>• The memorandum and articles</td>
</tr>
<tr>
<td>• Other legal documents such as prospectuses, leases, sales agreements</td>
</tr>
<tr>
<td>• Details of the history of the entity's business</td>
</tr>
<tr>
<td>• Board minutes of continuing relevance</td>
</tr>
<tr>
<td>• Previous years’ signed financial statements, analytical review and management letters</td>
</tr>
<tr>
<td>• Accounting systems notes, previous years’ control questionnaires</td>
</tr>
<tr>
<td><strong>Current audit files</strong> (containing information of relevance to the <strong>current year’s audit</strong>). These should be compiled on a timely basis after the completion of the audit and should contain:</td>
</tr>
<tr>
<td>• Financial statements</td>
</tr>
<tr>
<td>• Financial statements checklists</td>
</tr>
<tr>
<td>• Management financial statements details</td>
</tr>
<tr>
<td>• Reconciliations of management and financial statements</td>
</tr>
<tr>
<td>• A summary of unadjusted errors</td>
</tr>
<tr>
<td>• Report to partner including details of significant events and errors</td>
</tr>
<tr>
<td>• Review notes</td>
</tr>
<tr>
<td>• Audit planning memorandum</td>
</tr>
<tr>
<td>• Time budgets and summaries</td>
</tr>
<tr>
<td>• Representation letter</td>
</tr>
<tr>
<td>• Management letter</td>
</tr>
<tr>
<td>• Notes of board minutes</td>
</tr>
<tr>
<td>• Communications with third parties such as experts or other auditors</td>
</tr>
</tbody>
</table>

They 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 review
- 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 errors 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 a modem 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

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 ie adding 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
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
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.
Auditors must obtain **sufficient appropriate** audit evidence. Audit evidence can be in the form of **tests of controls** or **substantive procedures**.

Audit tests 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**.

Audit evidence can be obtained by inspection, observation, inquiry and confirmation, recalculation, reperformance and analytical procedures.

With a **'top down' approach** (also known as the business risk approach) controls testing is aimed at high level controls and substantive testing is reduced.

An auditor may predominantly test controls and systems, but substantive testing can **never** be eliminated entirely.

An auditor may choose predominantly to carry out substantive tests on year end balances.

Directional testing is a method of discovering errors and omissions in financial statements.

Auditors usually seek evidence from less than 100 per cent of items of the balance or transaction being tested by using **sampling techniques**.

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.
Answers to self-test questions

Answer 1

(a) General considerations in evaluating audit evidence

The auditors must obtain evidence which is **sufficient and appropriate** to form the basis for their audit conclusions. The evidence gathered should also be **relevant** to those conclusions, and sufficiently **reliable** to form the basis for the audit opinion. The auditors must exercise skill and judgment to ensure that evidence is correctly interpreted and that only valid inferences are drawn from it.

Certain general principles can be stated. **Written evidence** is preferable to oral evidence; **independent evidence** obtained from outside the entity is more reliable than that obtained internally; and **evidence generated by the auditors** is more reliable than that obtained from others.

(b) Quality of audit evidence

(i) Evidence originated by the auditors

This is in general the most reliable type of audit evidence because there is little risk that it can be manipulated by management.

**Examples**

1. Analytical procedures, such as the calculation of ratios and trends in order to examine unusual variations;
2. Physical inspection or observation, such as attendance at inventory counts; and
3. Reperformance of calculations making up figures in the financial statements, such as the computation of total inventory values.

(ii) Evidence composed by third parties

Third party evidence is more reliable than entity-produced evidence to the extent that it is obtained from independent sources. Its reliability will be reduced if it is obtained from sources which are not independent, or if there is a risk that entity personnel may be able to and have reason to suppress or manipulate it.

**Examples**

1. Circularisation of trade receivables or payables, confirmation of bank balances;
2. Reports produced by experts, such as property valuations, actuarial valuations, and legal opinions. In evaluating such evidence, the auditors need to take into account the expert's qualifications, independence and the terms of reference for the work; and
3. Documents held by the entity which were issued by third parties, such as invoices, price lists and statements. These may sometimes be manipulated by the entity and so are less reliable than confirmations received directly.

(iii) Evidence composed by management

The auditors cannot place the same degree of reliance on evidence produced by entity management as on that produced outside the company. However, it will often be necessary to place some reliance on such evidence. The auditors will need to obtain audit evidence that the information supplied is complete and accurate, and apply judgment in doing so, taking into account previous experience of the entity's reliability.
and the extent to which the entity's representations appear compatible with other audit findings, as well as the materiality of the item under discussion.

**Examples**

(1) The company's accounting records and supporting schedules. Although these are prepared by management, the auditors have a statutory right to examine such records in full: this right enhances the quality of this information.

(2) The entity's explanations of, for instance, apparently unusual fluctuations in results. Such evidence requires interpretation by the auditors and, being oral evidence, only limited reliance can be placed upon it; and

(3) Information provided to the auditors about the internal control system. The auditors need to confirm that this information is accurate and up-to-date, and that it does not simply describe an idealised system which is not adhered to in practice.

**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 error 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.
DEF Ltd

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
2. Laws and regulations
3. Following up illegal acts or fraud during the audit

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.
In this chapter you will cover the following learning outcomes:

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<thead>
<tr>
<th>Competency level</th>
<th>Learning outcomes</th>
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<tbody>
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<td>2.05</td>
<td>Planning and risk assessment</td>
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<td>2.05.08</td>
<td>Explain the effect of fraud and misstatements on audit planning and work</td>
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<td>2.05.09</td>
<td>Explain the effect of laws and regulations, and non-compliance therewith, on audit planning and procedures</td>
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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 terms
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. Fraud may be perpetrated by an individual, or colluded in, with people internal or external to the business.

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

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.

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 earning 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** is a particular type of fraud involving the wrongful taking an entity's assets.

**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

Fraud involves:

(a) **incentive or pressure to commit fraud** – this may mean management is under pressure to achieve unforeseeable earnings or may indicate personal financial difficulties

(b) **an opportunity** – this may be the presence of large amounts of cash or stock 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 (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 and should respond appropriately to fraud or suspected fraud identified during the audit.

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.

The auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, considering the honesty and integrity of management and those charged with governance.

The auditor should evaluate the design of the entity’s related controls, including relevant control activities and determine whether they have been implemented.

Although the auditor may suspect or identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.

### 1.4 Risk assessment

HKSA 240 (Clarified) *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements* 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 (Clarified), 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 both overstatement or understatement of revenue, for example:

- recording fictitious revenue causing
- 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

HKSA 240 (Clarified) requires that, irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to respond to presumed risks of management override controls as management often in a position that can override controls.

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

In accordance with HKSA 330 (Clarified) The Auditor's Responses to Assessed Risks, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. In this regard, the auditor shall:

(a) assign and supervise staff responsible taking into account their knowledge, skill and ability ie individuals with specialized 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 315 (Clarified) 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 incur:

<table>
<thead>
<tr>
<th>Fraud risk factors relating to fraudulent financial reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating</strong></td>
</tr>
<tr>
<td>• Missing vouchers</td>
</tr>
<tr>
<td>• Falsified documents and unsatisfactory explanations</td>
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<tr>
<td>• Evidence of dispute</td>
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<tr>
<td>• Unexplained reconciliations or incomplete accounting records</td>
</tr>
<tr>
<td>• Computer files failure – lack of records</td>
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<tr>
<td>• Significant related party transactions occurred not in the ordinary course of business</td>
</tr>
<tr>
<td>• Dominant position in the market that may result in inappropriate or non-arm’s length transactions</td>
</tr>
<tr>
<td>• Many estimates involved in the financial statements</td>
</tr>
<tr>
<td>• Significant bank accounts or subsidiaries or branches operations in tax-haven countries</td>
</tr>
<tr>
<td><strong>Financial</strong></td>
</tr>
<tr>
<td>• Financial and profitability levels being threatened due to high degree of competition, rapid changes in business environment</td>
</tr>
<tr>
<td>• Major decline in customer demand and increasing business failure</td>
</tr>
<tr>
<td>• Negative cash flow and operating losses</td>
</tr>
<tr>
<td>• New accounting/statutory/regulatory requirement</td>
</tr>
<tr>
<td>• Threat of bankruptcy/foreclosure/takeover</td>
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</tbody>
</table>
| Pressure on management | • 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 | • Significant related party transactions not in the course of ordinary business  
| | • Complex corporate structure  
| | • Multi-location businesses  
| Management style | • 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 | • 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 | • 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

<table>
<thead>
<tr>
<th>Internal controls</th>
<th>Management style</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Inadequate internal controls over assets</td>
<td>• Management disregarding the need for monitoring or reducing risks of</td>
</tr>
<tr>
<td>• Inadequate segregation of duties</td>
<td>misappropriation of assets</td>
</tr>
<tr>
<td>• Inadequate oversight of senior management and employees responsible for assets</td>
<td>• Non-financial management's excessive participation</td>
</tr>
<tr>
<td>• Inadequate recordkeeping, authorisation and approval and physical safeguards</td>
<td>• Continuous disputes between management and shareholders</td>
</tr>
<tr>
<td>over cash investments</td>
<td></td>
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<tr>
<td>• Lack of documentation of transactions</td>
<td></td>
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<tr>
<td>• Lack of security in automated records</td>
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<tr>
<td>• Lack of complete and timely reconciliation of assets</td>
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<tr>
<td>• Inadequate management understanding of information technology</td>
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</table>

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 (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:
1.9 **Analytical procedures performed near the end of the audit**

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**

When auditor encounters *exceptional circumstances* that affect auditor's ability to perform the audit, HKSA 240 (Clarified) requires the auditor to:

(a) determine the professional and legal responsibilities applicable in the circumstances ie obligatory disclosure; or

(b) consider the appropriateness to withdraw from the engagement.

Examples of exceptional circumstances include the following:

(a) No appropriate action regarding fraud is undertaken by the entity, where auditor considers necessary;  
(b) The auditor considers there is significant risk of material and pervasive fraud; or  
(c) 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:

(a) discuss with the appropriate level of management and those charged with governance about the withdrawal; or

(b) determine whether there is obligatory reporting to regulatory authorities.

1.11 **Written representations**

HKSA 240 (Clarified) requires the auditor to obtain *written representations* from management and those charged with governance that they:

(a) 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

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 weaknesses in internal controls, the auditor should communicate with management.

When auditors are not able to continue the audit due to misstatement of fraud, auditors should consider professional and legal responsibilities and the possibility of withdrawing from engagement.

1.13 Documentation

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

(a) Explain the auditors' responsibility pertaining to the detection of fraud and errors when a set of financial statements is audited.

(b) A fraud has been identified during the course of an audit. What actions, if any, should the auditors take if the entity being audited is incorporated in Hong Kong and is owned and operated by a businessman and his wife? (Specific reference to legal requirements is not necessary.)

(c) Will the auditors act differently if the entity being audited is a wholly-owned subsidiary whose holding entity is situated overseas?

(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 that 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.

'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. 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 litigations and non-financial consequences, such as loss of reputation.

2.2 Responsibility of management and those charged with governance
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.

(a) Monitor legal requirements and ensure that operating procedures are designed to meet these requirements;

(b) Institute and operate appropriate systems of internal control including internal audit and an audit committee;

(c) Develop, publicise and follow a code of conduct;

(d) 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.
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.

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, i.e., 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 shall 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 shall 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-compliances with laws and regulations

The auditor shall 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

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 shall discuss the matter and the
findings with management and, where appropriate, those charged with governance.

The auditor shall 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 auditor is not satisfied
with the opinion from the entity's legal counsel, 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 shall 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

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

#### 3.1 HKSA 240 (Clarified)

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)

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 supervisory authorities.
Topic recap

- The primary responsibility for the prevention and detection of fraud is with those charged with governance and the management of an entity.
- When planning, performing audit procedures, evaluating and reporting results in order to reduce the audit risks to an acceptable low level, auditor should consider the risks of material misstatements in financial statement due to fraud and error.
- Auditors are required to carry out the audit with an attitude of professional scepticism.
- When carrying out risk assessment procedures, the auditor shall also consider the risk of fraud or non-compliance with law and regulations causing a misstatement in financial statements.
- 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.
Answer to self-test question

Answer 1

(a) The auditors’ responsibility for the detection of fraud and errors when a set of financial statements is audited:

(i) HKSA 240 (Clarified) focuses on the auditors’ responsibilities with respect to fraud and errors. It establishes standards and provides guidance on the auditors’ responsibility to consider fraud and errors in an audit of financial statements. Pursuant to these requirements, the auditors should consider the risk of material misstatements in the financial statements resulting from fraud or errors when planning and performing audit procedures and evaluating and reporting the results thereof; or

(ii) The objective of an audit of the financial statements is to enable the auditors to express an opinion whether the financial statements are prepared, in all material respects, in accordance with Generally Accepted Accounting Principles in Hong Kong. An audit conducted in accordance with Hong Kong Standards on Auditing is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatements, whether caused by fraud or errors. The fact that an audit is carried out may act as a deterrent, but the auditors are not and cannot be held responsible for the prevention of fraud and errors.

(b) What actions should the auditors take when a fraud has been identified?

(i) It is an implied term of the auditors’ contract with their entity that the auditors will not generally disclose to other parties information about their entity’s affairs acquired during and as a result of their professional relationship, against their entity’s wishes. Accordingly, the auditors’ professional duty to maintain the confidentiality of client information ordinarily precludes reporting fraud and error to a party outside the entity.

(ii) The auditors should, except when prohibited by law from informing any party other than the proper authority or when the fraud casts doubt on the integrity of those charged with governance, communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance.

(iii) However, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law:

(1) These include circumstances when it is the public interest for auditors to report identified fraud to a proper authority; and

(2) Auditors also have a statutory duty to take the initiative to disclose to an authorised officer knowledge or suspicion that property represents proceeds of drug trafficking or other indictable offence.

(iv) The auditors should seek legal and other professional advice when they are in doubt.

(c) If the entity being audited is a wholly-owned subsidiary whose holding entity is situated overseas, the auditors may take actions, other than those set out above, of reporting the findings to the holding entity’s management and its auditors.
XXX Limited

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.

(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.

(Total = 15 marks)

HKICPA May 2007
chapter 11

Internal control and tests of controls

**Topic list**

1. Internal control systems
2. The use of internal control systems by auditors
3. Tests of controls
4. Internal controls in a computerised environment
5. Communicating deficiencies in internal control

**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. A new auditing standard on communicating deficiencies in internal control to those charged with governance and management has recently come into force.
In this chapter you will cover the following learning outcomes:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>Competency</th>
<th>Learning outcomes</th>
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</thead>
<tbody>
<tr>
<td>2.09 3</td>
<td>Audit procedures</td>
<td>Explain the importance of internal control to auditors</td>
</tr>
<tr>
<td>2.09.05 3</td>
<td></td>
<td>Explain how auditors identify weaknesses in internal control systems and how those weaknesses limit the extent of auditors’ reliance on those systems</td>
</tr>
<tr>
<td>2.10 3</td>
<td>Audit evidence</td>
<td>Explain the need to modify the audit strategy and audit plan following the results of tests of control</td>
</tr>
<tr>
<td>2.13 3</td>
<td>Reporting</td>
<td>Discuss and provide examples of how the reporting of internal control weaknesses and recommendations to overcome those weaknesses are provided to management</td>
</tr>
<tr>
<td>4.02 3</td>
<td>Categories and types of controls:</td>
<td></td>
</tr>
</tbody>
</table>
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 and implemented 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 (Clarified) 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 (Clarified) 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 compliance objectives. All these controls may be considered by auditors who would determine whether these controls are relevant to the audit.

In obtaining an understanding of internal control, the auditor must understand 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?). 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
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 auditor, 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 (Clarified) 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 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:

<table>
<thead>
<tr>
<th>Control environment</th>
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</thead>
<tbody>
<tr>
<td><strong>Management's integrity and ethical values</strong></td>
</tr>
<tr>
<td>- Essential elements which influence the effectiveness of the design, administration and monitoring of controls; and</td>
</tr>
<tr>
<td>- Overall attitude, awareness and actions of management on the internal control system</td>
</tr>
<tr>
<td><strong>Commitment to competence</strong></td>
</tr>
<tr>
<td>- Management's assessment of the competency levels for particular roles and how those levels translate into requisite skills and knowledge</td>
</tr>
<tr>
<td><strong>Participation by those charged with governance</strong></td>
</tr>
<tr>
<td>- Independence from management</td>
</tr>
<tr>
<td>- Experience and stature</td>
</tr>
<tr>
<td>- Extent of involvement and scrutiny of activities</td>
</tr>
<tr>
<td>- Type of difficult questions resolved in between internal and external auditors</td>
</tr>
<tr>
<td>- Whether they understand the entity's business transactions</td>
</tr>
<tr>
<td><strong>Management's philosophy and operating style</strong></td>
</tr>
<tr>
<td>- Approach to taking and managing business risks</td>
</tr>
<tr>
<td>- Attitudes and actions towards financial reporting</td>
</tr>
<tr>
<td>- Attitudes towards information processing and accounting functions and personnel</td>
</tr>
<tr>
<td><strong>Organisational structure</strong></td>
</tr>
<tr>
<td>- 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)</td>
</tr>
<tr>
<td><strong>Assignment of authority and responsibility</strong></td>
</tr>
<tr>
<td>- How authority and responsibility for business activities are allocated and how reporting lines and authorisation controls are organised</td>
</tr>
<tr>
<td><strong>Human resource policies and practices</strong></td>
</tr>
<tr>
<td>- How recruitment, induction, training, performance monitoring and career progression plans, work place counselling, remuneration, and grievance and discipline matters are conducted</td>
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</table>

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 (Clarified) says the auditor must evaluate the internal processes of an entity for the following:

- identification of the business risks which may affect financial reporting objectives
- evaluating their significance
- estimating 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 this with management.

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. It consists of the use of standard or non-standard journal entries used to initiate, record, process and report transactions and also to maintain accountability for the related assets, liabilities and equity.

The auditor must obtain an understanding of the information system relevant to financial reporting objectives, and the following in particular:

(a) The classes of transactions in the entity’s operations that are of most significance to the financial statements

(b) 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

(c) The underlying accounting records, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions

(d) How the information system records events and conditions, other than transactions, that are significant to the financial statements

(e) The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures

(f) 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

Small Trading Company Limited (STC) is a typical small trading entity with annual turnover of approximately HK$100,000,000. The owner-manager, Mr A, hires four support staff to perform all kinds of duties, including marketing, shipping, invoicing, collections and bookkeeping.
Required
As the auditor of STC, for the purpose of obtaining an understanding of STC’s internal controls:
(a) Identify major classes of transactions at STC.
(b) Document the procedures, the related accounting records and the related control activities, if any, you would expect to find in place at STC for one these major classes of transactions sales.

(1.4 Control activities)

Key term
Control activities are those policies and procedures which are established to achieve the entity's specific objectives and are designed to prevent, or to detect and correct errors.

HKSA 315 (Clarified) states that the auditor, shall obtain an understanding of control activities relevant to the audit. 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.

<table>
<thead>
<tr>
<th>Examples of control activities</th>
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<tbody>
<tr>
<td><strong>Authorisation</strong></td>
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<tr>
<td>- Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers</td>
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<tr>
<td><strong>Information processing</strong></td>
</tr>
<tr>
<td>- General IT controls – policies and procedures that relate to many applications such as program change controls</td>
</tr>
<tr>
<td>- Application controls – applying to the processing of individual applications</td>
</tr>
<tr>
<td><strong>Performance review</strong></td>
</tr>
<tr>
<td>- Reviews and analyses of actual performance versus budgets, forecasts</td>
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<tr>
<td>- Comparing different sets of data by analysing of the relationships and investigate the difference</td>
</tr>
<tr>
<td>- Comparing internal data with external sources of information</td>
</tr>
<tr>
<td>- Review of functional or activity performance</td>
</tr>
<tr>
<td><strong>Physical controls</strong></td>
</tr>
<tr>
<td>- Physical security of assets for prevention theft of assets</td>
</tr>
<tr>
<td>- Authorisation for access to computer programs and data files</td>
</tr>
<tr>
<td>- Periodic counting and comparison with amounts shown on control records</td>
</tr>
</tbody>
</table>
Examples of control activities

**Segregation of duties**
- **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 includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions.

HKSA 315 (Clarified) 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 obtain an understanding of the *nature of its responsibilities* and how it *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 (Clarified) 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.

### Self-test question 2

An internal control system has been described as comprising 'the control environment and control activities'. It includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information'.

**Required**

Explain the meaning and relevance to the auditors giving an opinion on financial statements of each of the management objectives above.  

*(The answer is at the end of the chapter)*

### 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 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
- Flowcharts
- Questionnaires
- 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
- **Internal Control Evaluation Questionnaires (ICEQs)** are used to determine whether there are controls which prevent or detect specified errors or omissions

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.
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 controls they anticipate should be in existence were in operation with regard to that transaction.

For any material weaknesses in the internal control system, the auditor should communicate to:

- those charged with governance; and
- management of an appropriate level of responsibility.

3.2 When to perform tests of controls

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, ie whether they are suitably designed to prevent, or detect and correct, material misstatement at the assertion level; and
- operation of the internal controls throughout the period.

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.

![Diagram: When should auditors perform tests of controls?](image)

When auditor's risk assessment includes an expectation of the operating effectiveness of control, the auditor is required to test those controls to support the risk assessment.

When substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor is required to perform tests of controls to obtain audit evidence about their operating effectiveness.

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 the following:

(a) **Inspection of documents** supporting controls or events to gain audit evidence that internal controls have operated properly, e.g. verifying that a transaction has been authorised;

(b) **Inquiries about internal controls** which leave no audit trail, e.g. determining who actually performs each function not merely who is supposed to perform it;

(c) **Reperformance of control procedures**, e.g. reconciliation of bank accounts, to ensure they were correctly performed by the entity;

(d) **Examination of evidence of management views**, e.g. minutes of management meetings;

(e) Testing of internal controls operating on **computerised systems** or over the overall IT function, e.g. 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 500 (Clarified) states that 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.

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 previous audits, the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit. The auditor should obtain audit evidence about whether such changes have occurred by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls.

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 that obtained from the auditor’s client acceptance or continuance process or, where practicable, experience gained on other engagements performed for the entity, for example, engagements to review interim financial information.

### 3.3.5 Communications of weaknesses of internal control
Significant weaknesses on 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 (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 technique 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 (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 misstatement that have been detected by substantive procedures indicate existence of a significant deficiency in internal control.

### Self-test question 3

HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment* deals with internal control objectives and internal controls. HKSA 500 (Clarified) *Audit Evidence* deals with audit objectives and audit procedures. 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**

(a) For the payroll department at Charter Great, describe the:

(i) internal control objectives that should be in place;
(ii) internal control environment and internal control procedures that should be in place to achieve the internal control objectives.

(b) For the payroll charges and payroll balances (including cash) in the financial statements of Charter Great:

(i) describe the external auditor audit's objectives;
(ii) 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.

Key terms
General IT 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. It aims to establish a framework of overall control over the computer information system’s activities. They commonly include controls over data centre and network operations, system software acquisition, change and maintenance, access security, and application system acquisition, development and maintenance.

Application controls are manual or automated procedures that specifically operate at a business process level. They can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, they relate to specific procedures used to initiate, record, process and report transactions or other financial data.

4.1 General controls

<table>
<thead>
<tr>
<th>General controls</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development of computer applications</td>
<td>Standards over systems design, programming and documentation</td>
</tr>
<tr>
<td></td>
<td>Full testing procedures using test data</td>
</tr>
<tr>
<td></td>
<td>Approval by computer users and management</td>
</tr>
<tr>
<td></td>
<td>Segregation of duties so that those responsible for design are not responsible for testing</td>
</tr>
<tr>
<td></td>
<td>Installation procedures so that data is not corrupted in transition</td>
</tr>
<tr>
<td></td>
<td>Training of staff in new procedures and availability of adequate documentation</td>
</tr>
<tr>
<td>Prevention or detection of unauthorised changes to programs</td>
<td>Segregation of duties</td>
</tr>
<tr>
<td></td>
<td>Full records of program changes</td>
</tr>
<tr>
<td></td>
<td>Password protection of programs so that access is limited to computer operations staff</td>
</tr>
<tr>
<td></td>
<td>Restricted access to central computer by locked doors, keypads</td>
</tr>
<tr>
<td>General controls</td>
<td>Examples</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>--------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Maintenance of programs logs</td>
<td></td>
</tr>
<tr>
<td>Virus checks on software: use of anti-virus software and policy prohibiting use of non-authorised programs or files</td>
<td></td>
</tr>
<tr>
<td>Back-up copies of programs being taken and stored in other locations</td>
<td></td>
</tr>
<tr>
<td>Control copies of programs being preserved and regularly compared with actual programs</td>
<td></td>
</tr>
<tr>
<td>Stricter controls over certain programs (utility programs) by use of read-only memory</td>
<td></td>
</tr>
<tr>
<td>Testing and documentation of program changes</td>
<td>Complete testing procedures</td>
</tr>
<tr>
<td></td>
<td>Documentation standards</td>
</tr>
<tr>
<td></td>
<td>Approval of changes by computer users and management</td>
</tr>
<tr>
<td></td>
<td>Training of staff using programs</td>
</tr>
<tr>
<td>Controls to prevent wrong programs or files being used</td>
<td>Operation controls over programs</td>
</tr>
<tr>
<td></td>
<td>Libraries of programs</td>
</tr>
<tr>
<td></td>
<td>Proper job scheduling</td>
</tr>
<tr>
<td>Controls to prevent unauthorised amendments to data files</td>
<td>Password protection</td>
</tr>
<tr>
<td></td>
<td>Restricted access to authorised users only</td>
</tr>
<tr>
<td></td>
<td>Authorisation of jobs prior to processing (eg authorised data input forms)</td>
</tr>
<tr>
<td>Controls to ensure continuity of operation</td>
<td>Storing extra copies of programs and data files off-site</td>
</tr>
<tr>
<td></td>
<td>Protection of equipment against fire and other hazards</td>
</tr>
<tr>
<td></td>
<td>Back-up power sources</td>
</tr>
<tr>
<td></td>
<td>Disaster recovery procedures, eg availability of back-up computer facilities</td>
</tr>
<tr>
<td></td>
<td>Maintenance agreements and insurance</td>
</tr>
</tbody>
</table>

The auditors will wish to test some or all of the above general IT controls, having considered how they affect the computer applications significant to the audit.

General IT 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 IT 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.
Application controls include the following:

<table>
<thead>
<tr>
<th>Application controls</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Controls over input:</td>
<td>Manual or programmed agreement of control totals</td>
</tr>
<tr>
<td>completeness</td>
<td>Document counts</td>
</tr>
<tr>
<td></td>
<td>Edit checks of input data</td>
</tr>
<tr>
<td></td>
<td>Numerical sequence checks with manual follow-up of exception reports</td>
</tr>
<tr>
<td></td>
<td>One-for-one checking of processed output to source documents</td>
</tr>
<tr>
<td></td>
<td>Programmed matching of input to an expected input control file</td>
</tr>
<tr>
<td>Procedures over resubmission</td>
<td>of rejected controls</td>
</tr>
<tr>
<td>Controls over input:</td>
<td>Programmes to check data fields (for example, value, reference number, date) on input transactions for plausibility:</td>
</tr>
<tr>
<td>accuracy</td>
<td>• Digit verification (reference numbers are as expected)</td>
</tr>
<tr>
<td></td>
<td>• Reasonableness test (sales tax to total value)</td>
</tr>
<tr>
<td></td>
<td>• Existence checks (customer name)</td>
</tr>
<tr>
<td></td>
<td>• Character checks (no unexpected characters used in reference)</td>
</tr>
<tr>
<td></td>
<td>• Necessary information (no transaction passed with gaps)</td>
</tr>
<tr>
<td></td>
<td>• Permitted range (no transaction processed over a certain value)</td>
</tr>
<tr>
<td>Manual scrutiny</td>
<td>of output and reconciliation to source</td>
</tr>
<tr>
<td>Agreement of control totals</td>
<td>(manual/programmed)</td>
</tr>
<tr>
<td>Controls over input:</td>
<td>Manual checks to ensure information input was:</td>
</tr>
<tr>
<td>authorisation</td>
<td>• authorised</td>
</tr>
<tr>
<td></td>
<td>• input by authorised personnel</td>
</tr>
<tr>
<td>Controls over processing</td>
<td>Similar controls to input must be in place when input is completed, for example, batch reconciliations</td>
</tr>
<tr>
<td></td>
<td>Screen warnings can prevent people logging out before processing is complete</td>
</tr>
<tr>
<td>Controls over master files and standing data</td>
<td>One-to-one checking</td>
</tr>
<tr>
<td></td>
<td>Cyclical reviews of all master files and standing data</td>
</tr>
<tr>
<td></td>
<td>Record counts (number of documents processed) and hash totals</td>
</tr>
<tr>
<td></td>
<td>(for example, the total of all the payroll numbers) used when master files are used to ensure no deletions</td>
</tr>
<tr>
<td></td>
<td>Controls over the deletion of accounts that have no current balance</td>
</tr>
</tbody>
</table>

Controls over input, processing, data files and output 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:

<table>
<thead>
<tr>
<th>Testing of application controls</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Manual controls exercised by the user</td>
<td>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.</td>
</tr>
</tbody>
</table>
Testing of application controls

<table>
<thead>
<tr>
<th>Controls over system output</th>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Programmed control procedures</td>
<td>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.</td>
</tr>
</tbody>
</table>

As we have already noted, general IT 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 IT controls may preclude testing certain IT application controls, it is possible that manual procedures exercised by users may provide effective control at the application level.

Self-test question 4

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 per cent 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 weaknesses in the internal controls of XYZ. Discuss the implications of each of the weaknesses 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)

4.3 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 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

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.

### 5.1 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 unprevented 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 of 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 (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

The auditor shall discuss the relevant facts and circumstances of his findings on deficiencies in internal control with the appropriate level of management 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; and

(h) Communication for those charged with governance.

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 Management and those charged with governance’s actions towards deficiencies

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.
The auditors must understand the accounting system and control environment in order to determine their audit approach.

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.

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.

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 special considerations for auditors when a system is computerised. IT controls comprise general and application controls.

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.
Answer 1

(a) Classes of transactions that are significant to STC's financial statements include:

1. sales of goods;
2. purchases of inventories; and
3. cash collections from customers and disbursements to suppliers.

Information about these classes of transactions recorded in the day books is transferred to the general ledger manually through posting.

Procedures by which sales transactions are initiated, recorded, processed and reported in the financial statements, and the related accounting records, supporting information, and specific accounts are documented in (b).

(b) **System documentation for sales**

<table>
<thead>
<tr>
<th>Information system description</th>
<th>Control activities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transaction initiation</strong></td>
<td></td>
</tr>
<tr>
<td>Revenue transactions are initiated on receipt of purchase orders from customers.</td>
<td>Authorisation of goods delivery by Mr A. This addresses the occurrence of sales.</td>
</tr>
<tr>
<td>Goods delivery notes are prepared by the sales personnel instructing warehouse to deliver goods.</td>
<td>Good delivery notes/sale invoice in numerical sequence are reviewed periodically to ensure all goods delivered are recorded. This application control addresses the completeness of sales.</td>
</tr>
<tr>
<td><strong>Transaction recording and processing</strong></td>
<td></td>
</tr>
<tr>
<td>Goods deliveries acknowledged by customers are recorded in sales journal by administration clerk.</td>
<td>Entries to sales journal are reviewed and checked by administrative manager. This application control addresses all assertions of sales.</td>
</tr>
<tr>
<td>Qualities delivered, unit selling prices and invoiced amounts are checked by administration clerk, who calculates/checks the invoiced total.</td>
<td>Arithmetical accuracy of invoiced total are checked by administrative manager. This application control addresses the accuracy of sales.</td>
</tr>
<tr>
<td>Issuance of invoices are reviewed and authorised by Mr A. This addresses the occurrence of sales.</td>
<td>Segregation of duties in initiating, recording and authorisation of revenue transactions. This addresses all assertions of sales.</td>
</tr>
</tbody>
</table>
### Information system description

<table>
<thead>
<tr>
<th>Total credit sales of each business day are summarised and reconciled to movements in receivables ledgers by administration clerk.</th>
<th>Reconciliations of credit sale to movement in receivables ledgers/reconciliations of cash sales to cash books are application controls to maintain integrity of information processed, addressing all assertions generally.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total cash sales of each business day are summarised and reconciled to movements in cash books by the administration clerk.</td>
<td>Reviews of such reconciliations by the administrative manager comprise monitoring of controls, addressing all the assertions generally.</td>
</tr>
<tr>
<td>Total sales for a business day, total increase in trade receivables and total increase in cash are posted to the general ledger by the administration clerk.</td>
<td>Review and authorisation of postings to general ledgers by administrative manager. This application control addresses all assertions of sales.</td>
</tr>
<tr>
<td>Cash and credit sales for a day are recorded in the general ledgers as follows:</td>
<td></td>
</tr>
<tr>
<td><strong>DR</strong></td>
<td><strong>Cash and bank balances</strong></td>
</tr>
<tr>
<td><strong>DR</strong></td>
<td><strong>Trade receivables</strong></td>
</tr>
<tr>
<td><strong>CR</strong></td>
<td><strong>Revenue – sales of goods</strong></td>
</tr>
</tbody>
</table>

### Reporting of revenue transactions

Monthly sales reports are prepared by sales personnel and reviewed by Mr A.  
Actual sales performance is compared to budgeted sales/forecasted sales/actual sales of the corresponding prior period.  
All the reporting and reviewing of sales are a form of control activity (performance review) addressing all the assertions of the sales transactions generally.

### Answer 2

The auditors’ objective in evaluating and testing internal controls is to determine the degree of reliance which they may place on the information contained in the accounting records. If they obtain reasonable assurance by means of tests of controls that the internal control system is effective in ensuring the completeness and accuracy of the accounting records, they may limit their substantive procedures.

(a) *The orderly and efficient conduct of its business*

An entity which is efficient and conducts its affairs in an orderly manner is much more likely to be able to supply the auditors with sufficient appropriate audit evidence on which to base their audit opinion. More importantly, the level of inherent and control risk will be lower, giving extra assurance that the financial statements do not contain material errors.

(b) *Adherence to internal policies*

Management is responsible for setting up an effective system of internal control and management policy provides the broad framework within which internal controls have to operate. Unless management does have a pre-determined set of policies, then it is very difficult to imagine how the company could be expected to operate efficiently. Management
policy will cover all aspects of the entity's activities, ranging from broad corporate objectives to specific areas such as wage rates.

Given that the auditors must have a sound understanding of the entity's affairs generally, and of specific areas of control in particular, then the fact that management policies are followed will make the task of the auditors easier in that they will be able to rely more readily on the information produced by the systems established by management.

(c) ‘Safeguarding of assets’

This objective may relate to the physical protection of assets (for example, locking cash in a safe at night) or to less direct safeguarding (for example, ensuring that there is adequate insurance cover for all assets). It can also be seen as relating to the maintenance of proper records in respect of all assets.

The auditors will be concerned to ensure that the entity has properly safeguarded its assets so that they can form an opinion on the existence of specific assets and whether the entity's records can be taken as a reliable basis for the preparation of financial statements. Reliance on the underlying records will be particularly significant where the figures in the financial statements are derived from such records rather than as the result of physical inspection.

(d) ‘Prevention and detection of fraud and error’

The directors are responsible for taking reasonable steps to prevent and detect fraud. They are also responsible for preparing financial statements which give a true and fair view of the entity's affairs. However, the auditors must plan and perform their audit procedures and evaluate and report the results of these, recognising that fraud or error may materially affect the financial statements.

A strong system of internal control will give the auditors some assurance that frauds and errors are not occurring, unless management are colluding to overcome that system.

(e) ‘Accuracy and completeness of the accounting records’/’timely preparation of reliable financial information’

This objective is most clearly related to statutory requirements relating to both management and auditors. The entity generally has legal obligations to maintain proper accounting records. The auditors must form an opinion on whether the entity has fulfilled these obligations and also conclude whether the financial statements agree with the underlying records.

Answer 3

(a) (i) Internal control objectives

Control objectives include policies and procedures designed by management to:

(1) Achieve accuracy and completeness of the accounting records and timely preparation of reliable financial information; this would include making correct payments and deductions from the payroll, correct payments for tax and social insurance, and making payments for work performed only (not to dummy employees, for example), in order that quarterly or half-yearly financial statements can be prepared (possibly), but in any case in order that annual financial statement can be prepared within the time limits.

(2) Prevent and detect fraud and error – fraud and error would include incorrect payments or deductions from the payroll and payments of incorrect amounts for tax and social insurance, payments for work not performed and payments to dummy employees, for example.

(3) Achieve the orderly and efficient running of the business including adherence to internal policies – this would include the regular, accurate processing and recording of payroll payments.
(4) Safeguard assets – this would include the physical safeguarding of cash and safeguarding money held in bank accounts by means of other controls.

(ii) Internal control environment and control procedures
The control environment relates to:

(1) Segregation of duties and supervisory controls to avoid the misappropriation of cash (or allegations thereof) and to avoid fraudulent collusion to create, for example, dummy employees or to make inflated payments – this prevents the loss of assets and/or inaccurate records.

(2) Management's overall style in encouraging awareness of the need for good controls, for example.

(3) The existence of organisational controls such as review of the payroll by an independent person such as the Chief Executive Officer, and the rotation of payroll duties among staff responsible for processing it – this helps achieve all of the objectives set out above.

Internal control procedures include:

(4) Approval and control of documents, such as the authorisation of the payroll itself, and authorisation for the bank to make transfers and to deliver cash.

(5) Controls over computerised applications, checking the arithmetical accuracy of documents and the maintenance of control accounts – this can be achieved by, for example, the use of timesheets or clockcards, the use of reliable software with programmed controls for the calculation of deductions, and the use of batch and hash totals for information that is input into the computer system. This helps achieve the orderly and efficient running of the business and the accuracy and completeness of records and financial statements.

(6) Limiting direct physical access to the cash, such as the use of a security firm to deliver cash, locking doors to areas where cash is held, keeping cash in a fire-proof safe and the protection of the computer by password controls – this will help safeguard assets and ensure the completeness and accuracy of the records and financial statements.

(b) 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 4**

(a)

<table>
<thead>
<tr>
<th>Internal control weaknesses</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Order of raw materials is based on prior month’s usage and computer generated purchase orders are not reviewed prior to being sent.</td>
<td>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.</td>
</tr>
<tr>
<td>Neither Goods Received Notes (‘GRNs’) nor purchase orders are numbered.</td>
<td>It will be difficult to follow up unfulfilled orders or account for missing/spoil documents without numbering. Liability for raw materials orders may have not been recorded in a timely manner.</td>
</tr>
<tr>
<td>No checking of goods received inside of boxes to ensure that the product type, quality and quantities are correct.</td>
<td>Records of inventory may not accurately reflect the actual status of inventory on hand.</td>
</tr>
<tr>
<td>Lack of procedures if scanning process aborted.</td>
<td>There may be unrecorded items/untimely recording of items.</td>
</tr>
<tr>
<td>No records of raw materials held by subcontractor and no system to follow up any long outstanding raw materials held by sub-contractors.</td>
<td>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.</td>
</tr>
</tbody>
</table>
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.
DEF Ltd
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.

Required
Describe the possible procedures for the test of controls on cash balance at outlets.  

(4 marks)

HKICPA September 2006 (amended)
chapter 12

Substantive procedures, including analytical procedures

**Topic list**

1. Substantive procedures
2. Analytical procedures

**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:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>Competency</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>2.09</td>
<td>Audit procedures</td>
</tr>
<tr>
<td></td>
<td>2.09.07</td>
<td>Explain the types of substantive procedures</td>
</tr>
<tr>
<td></td>
<td>2.09.08</td>
<td>Explain what is meant by analytical review and how analytical review procedures are used in an audit</td>
</tr>
</tbody>
</table>
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 should plan and perform substantive procedures that are **specifically responsive** to that risk.

### 1.1 Types of audit tests

**Substantive procedures** are tests to obtain audit evidence to detect material misstatements in the financial statements. 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.

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:

<table>
<thead>
<tr>
<th>Substantive analytical procedures</th>
<th>Tests of details</th>
</tr>
</thead>
<tbody>
<tr>
<td>• More applicable to <strong>large volumes</strong> of transactions</td>
<td>• For testing <strong>classes of transactions</strong> and account balances ie existence and valuations</td>
</tr>
<tr>
<td>• Auditors should investigate any unusual items deviated from expectation</td>
<td>• Objective to obtain <strong>sufficient and appropriate audit evidence</strong> at the <strong>assertion level</strong></td>
</tr>
<tr>
<td>• Consider any expected relationships and obtain adequate explanations and appropriate corroborative evidence</td>
<td></td>
</tr>
<tr>
<td>• Documentation is required</td>
<td></td>
</tr>
<tr>
<td>• Consider any relationships from known conditions</td>
<td></td>
</tr>
<tr>
<td>• To apply analytical procedures, information needs to be sufficiently complete and accurate</td>
<td></td>
</tr>
<tr>
<td>• Should be applied when more reliable when controls are reliable</td>
<td></td>
</tr>
</tbody>
</table>

**Substantive testing**

- **Substantive analytical procedures**
  - Use when
    - less risky, predictable results
    - high turnover; lots of transactions
  - Use when
    - more risky and subject to more verification

**Substantive testing on statement of financial position's financial assertions**

- **Account balances**
  - **Existence**
  - **Completeness**
    - **Rights and obligations**
    - **Presentation and disclosure**
    - **Valuation and allocations**
1.3 **External confirmation as substantive audit procedures**

HKSA 330 (Clarified) *The Auditor’s Responses to Assessed Risks* 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.

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

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:

<table>
<thead>
<tr>
<th>Audit assertion</th>
<th>Type of assertion</th>
<th>Typical audit tests</th>
</tr>
</thead>
<tbody>
<tr>
<td>Completeness</td>
<td>Classes of transactions</td>
<td>(a) Review subsequent events</td>
</tr>
<tr>
<td></td>
<td>Account balances</td>
<td>(b) Cut-off testing</td>
</tr>
<tr>
<td></td>
<td>Presentation and</td>
<td>(c) Analytical review</td>
</tr>
<tr>
<td></td>
<td>disclosure</td>
<td>(d) Confirmations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(e) Reconciliations to control accounts</td>
</tr>
</tbody>
</table>
### Audit assertion

<table>
<thead>
<tr>
<th>Rights and obligations</th>
<th>Account balances</th>
<th>(a) Reviewing invoices for proof that item belongs to the entity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Presentation and disclosure</td>
<td>(b) Confirmations with third parties</td>
</tr>
<tr>
<td>Valuation and allocation</td>
<td>Account balances</td>
<td>(a) Matching amounts to invoices</td>
</tr>
<tr>
<td></td>
<td>Presentation and disclosure</td>
<td>(b) Recalculation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(c) Confirming accounting policy consistent and reasonable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(d) Review of post year-end payments and invoices</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(e) Expert valuation</td>
</tr>
<tr>
<td>Existence</td>
<td>Account balances</td>
<td>(a) Physical verification</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(b) Third party confirmations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(c) Cut-off testing</td>
</tr>
<tr>
<td>Occurrence</td>
<td>Classes of transactions</td>
<td>(a) Inspection of supporting documentation</td>
</tr>
<tr>
<td></td>
<td>Presentation and disclosure</td>
<td>(b) Confirmation from directors that transactions relate to business</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(c) Inspection of items purchased</td>
</tr>
<tr>
<td>Accuracy</td>
<td>Classes of transactions</td>
<td>(a) Recalculation of correct amounts</td>
</tr>
<tr>
<td></td>
<td>Presentation and disclosure</td>
<td>(b) Third party confirmation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(c) Analytical review</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(d) Valuation by expert</td>
</tr>
<tr>
<td>Classification and understandability</td>
<td>Classes of transactions</td>
<td>(a) Confirming compliance with laws and accounting standards</td>
</tr>
<tr>
<td></td>
<td>Presentation and disclosure</td>
<td>(b) Reviewing notes for understandability</td>
</tr>
<tr>
<td>Cut-off</td>
<td>Classes of transactions</td>
<td>(a) Cut-off testing</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(b) Analytical review</td>
</tr>
</tbody>
</table>

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 statements

### 1.5 Extent of substantive procedures

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) Auditing Sampling and Other Means of Testing 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.

1.6 Timing of substantive procedures

1.6.1 Substantive testing at interim date

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 should 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.

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 (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.

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 overleaf should not be regarded as prescriptive.
HKSA 315 (Clarified) Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and Its Environment

1. Accounting system
2. Control system
3. Control procedures

Procedures: Walk-through test, inquiries, review documents, observation, inspection

Develop Overall Audit Plan

Walk-through tests to confirm understanding of internal control

Document understanding on internal control system

HKSA 315 (Clarified) Preliminary Assessment of Control Risk
(Assessment of control risk should always be high) unless auditors are able to identify internal controls likely to prevent and correct a material misstatement.

The auditor's response to assessed risk for planning to perform test of control to support assessment.

High Risk

Medium Risk

Low Risk

No tests of control (only substantive testing)

Extend understanding of internal controls, ie monitor controls, computer or applications controls - confirming which controls are effective

Tests of control

Operational effectiveness

Determine which internal controls to rely on

Document further understanding on internal control system

Perform appropriate substantive testing - consider (NBT) - nature, extent and timing

Perform minimum substantive testing - ie confirm preliminary assessment and perform only analytical procedures
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 are tests conducted during an audit designed to help an auditor understand an entity’s business and any likely areas of misstatement.

According to HKSA 520 (Clarified) Analytical Procedures, 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 (Clarified) and HKSA 520 (Clarified) as essential:
(a) As risk assessment procedures to obtain an understanding of the entity and its environment
(b) As substantive procedures, either alone or in combination with tests of details
(c) Towards the end of the audit to help inform the overall conclusion as to the reasonableness of the financial statements assertions.

2.1 Analytical procedures as risk assessment procedures
HKSA 315 (Clarified) requires that the risk assessment procedures shall include analytical procedures as well as inquiries of management, 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 in related to current industry conditions
- board minutes
- any external correspondence
- non-financial information

### 2.2 Substantive analytical procedures

The HKSA 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:

   (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 is 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 has 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 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 (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:

- **By comparing** them with the auditors’ knowledge of the entity’s business and with other evidence obtained during the course of the audit; or
- **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:

- **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;
- **Trend analysis.** Sophisticated statistical techniques can be used to compare this period with previous periods; or
- **Reasonableness test.** This involves calculating the expected value of an item and comparing it with its actual value, for example, for straight-line depreciation.

\[
\text{(Cost + Additions – Disposals) } \times \text{Depreciation } \% = \text{Charge in statement of comprehensive income}
\]

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

A CPA plans on using analytical procedures in an upcoming audit. The entity has provided all information that was requested by the CPA to perform the procedures. Briefly discuss the following:

(a) What are the main advantages of performing analytical procedures in the risk assessment and overall review stages of the audit?

(b) What are the potential disadvantages?

(The answer is at the end of the chapter)
Auditors need to obtain **sufficient appropriate audit evidence** to support the financial statement assertions. Substantive procedures aim to obtain that evidence.

Substantive tests are designed to discover errors or omissions.

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**.
Answer 1

(a) The CPA plans on using analytical procedures in the upcoming audit because he is required to do so by HKSA 520 (Clarified) Analytical Procedures. Advantages of performing analytical procedures in the risk assessment stages of an audit include efficiencies in identifying areas requiring additional audit work, understanding relationships between financial statements, and in risk assessment. Comparison between prior year audited financial statements and the pro forma financial statements for the current year are an example of an efficient analytical procedure to identify areas that require concerted audit efforts. These same advantages exist when applying analytical procedures in the final review stages of an audit. The proposed final account balances can be readily compared to the final adjusted balances of the prior period for reasonableness. In addition, overall relationships between financial statements are evident in the final stages of the audit and analytical procedures assist in establishing that these relationships are in accordance with auditor expectations.

(b) Potential disadvantages of using analytical procedures include the lack of in-depth knowledge regarding the actual performance of the entity. Auditors unfamiliar with the entity or particular industry practices may be satisfied with the general results of analytical procedures in the risk assessment stages and fail to identify areas requiring special attention. For example, if industry norms or year-to-year comparisons are made, results within a certain range would be considered reasonable and pass further review. However, it is possible that the entity is idiosyncratic and has unique and unusual results which are undetected because the analytical review placed them within a 'normal' range. Disadvantages at the review stages of the audit also exist because of the emphasis placed on the analytical procedures may result in their remaining within a reasonable range, rather than providing clear-cut assurance that the auditor has selected and evaluated adequate evidence. These disadvantages are mitigated by materiality, and by the fact that substantive tests still must be performed to support initial assertions.
### Sources of evidence

In each of the four following situations, the auditors face two sources of evidence resulting from their audit procedures.

<table>
<thead>
<tr>
<th>Situation 1</th>
<th>Source A</th>
<th>Source B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Observation of the client’s physical counting of inventories at the year-end.</td>
<td>Confirmation of the client’s inventories held at an independent warehouse by requesting a confirmation from the warehouse management.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Situation 2</th>
<th>Source A</th>
<th>Source B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Observation of the client’s inventories composed primarily of sophisticated electronic equipments.</td>
<td>Observation of the client’s inventories composed primarily of metal sheets.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Situation 3</th>
<th>Source A</th>
<th>Source B</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
<td>Request for suppliers’ confirmations at the year-end for all significant suppliers from which the client made purchases during the year.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Situation 4</th>
<th>Source A</th>
<th>Source B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Confirmation of the client’s bank balance at the year-end direct with the bank.</td>
<td>Checking the balance of the client’s bank accounts with bank statements kept by the client.</td>
<td></td>
</tr>
</tbody>
</table>

**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

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.
In this chapter you will cover the following learning outcomes:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>Audit procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.09</td>
<td>Explain the appropriate audit tests for:</td>
</tr>
<tr>
<td>2.09.09</td>
<td>Tangible non-current assets</td>
</tr>
<tr>
<td>2.09.09.01</td>
<td>Intangible non-current assets</td>
</tr>
<tr>
<td>2.09.09.02</td>
<td>Inventory</td>
</tr>
<tr>
<td>2.09.09.03</td>
<td>Receivables</td>
</tr>
<tr>
<td>2.09.09.04</td>
<td>Bank and cash</td>
</tr>
<tr>
<td>2.09.09.05</td>
<td>Trade payables and accruals</td>
</tr>
<tr>
<td>2.09.09.06</td>
<td>Non-current liabilities</td>
</tr>
<tr>
<td>2.09.09.07</td>
<td>Provisions and contingencies</td>
</tr>
<tr>
<td>2.09.09.08</td>
<td>Capital and other issues</td>
</tr>
<tr>
<td>2.09.09.09</td>
<td>Long-term investments</td>
</tr>
<tr>
<td>2.09.09.10</td>
<td>Segment information</td>
</tr>
<tr>
<td>2.09.09.11</td>
<td>Revenue</td>
</tr>
<tr>
<td>2.09.09.12</td>
<td>Purchases</td>
</tr>
<tr>
<td>2.09.09.13</td>
<td>Wages and salaries</td>
</tr>
<tr>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>
1 Tangible non-current assets

1.1 Audit objectives for tangible non-current assets

<table>
<thead>
<tr>
<th>Financial statement assertion</th>
<th>Audit objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence and occurrence</td>
<td>• Additions represent assets acquired in the year and disposal represent assets sold or scrapped in the year</td>
</tr>
<tr>
<td></td>
<td>• Recorded assets represent those in use at the year-end</td>
</tr>
<tr>
<td>Completeness</td>
<td>• All additions and disposals that occurred in the year have been recorded</td>
</tr>
<tr>
<td></td>
<td>• Balances represent assets in use at the year-end</td>
</tr>
<tr>
<td>Rights and obligations</td>
<td>• The entity has rights to the assets purchased and those recorded at the year-end</td>
</tr>
<tr>
<td>Accuracy, classification and valuation</td>
<td>• Non-current assets are correctly stated at cost less accumulated depreciation</td>
</tr>
<tr>
<td></td>
<td>• Additions and disposals are correctly recorded</td>
</tr>
<tr>
<td>Assertions relating to presentation and disclosure</td>
<td>• 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</td>
</tr>
</tbody>
</table>

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
- Obtain or prepare a summary of tangible non-current assets showing how:
  - 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
- 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:
  - 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
- Verify valuation to valuation certificate.
- Consider the source of valuation, reviewing:
  - 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 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.

- 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.

- **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.
AUDIT PLAN: TANGIBLE NON-CURRENT ASSETS

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 truck is $37.5 million as at the year end and it represents 35 per cent of CML’s total assets.

Required
Describe the audit procedures the auditor should perform on the net book value CML’s trucks for the year ended.

(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
According to HKSA 501 (Clarified) Audit Evidence – Specific Considerations for Selected Items 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

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 follow:
(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** | • Agree the consideration to sales agreement by **inspection**  
• Consider whether asset valuation 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** | • 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** | • 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:
13: Specific audit procedures | Part D Assurance engagements

| Existence assertion | • 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 | • 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 considerate the assumptions on which the estimate is based. For example, by comparing estimates made for prior periods with actual results of those period  
• 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 |

### 3 Inventory

#### Topic highlights

There are five key assertions relating to inventory:

- **Existence**
- **Completeness**
- **Rights and obligations**
- **Valuation**
- **Cut-off**

The audit of inventory can pose problems for auditors as a result of its nature and potential material value on the statement of financial position. The audit approach taken depends on the auditor's assessment of the controls in place.
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.

<table>
<thead>
<tr>
<th>Financial statement assertion</th>
<th>Audit objective</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Existence and occurrence</strong></td>
<td>• Recorded purchases and sales represent inventories bought and sold.</td>
</tr>
<tr>
<td></td>
<td>• Inventory on the statement of financial position physically exists.</td>
</tr>
<tr>
<td><strong>Completeness</strong></td>
<td>• All purchases and sales are recorded.</td>
</tr>
<tr>
<td></td>
<td>• All inventory at year-end is included on the statement of financial position.</td>
</tr>
<tr>
<td><strong>Rights and obligations</strong></td>
<td>• The entity has rights to inventory recorded in the period and at the year-end.</td>
</tr>
<tr>
<td><strong>Accuracy, classification and valuation</strong></td>
<td>• Costs are accurately determined in accordance with accounting standards.</td>
</tr>
<tr>
<td></td>
<td>• Inventory is recorded at year-end at the lower of cost and net realisable value.</td>
</tr>
<tr>
<td><strong>Cut-off</strong></td>
<td>• All purchases and sales of inventories are recorded in the correct period.</td>
</tr>
<tr>
<td><strong>Assertions relating to presentation and disclosure</strong> (classification and understandability, completeness, accuracy and valuation)</td>
<td>• Inventory is properly classified in the financial statements.</td>
</tr>
<tr>
<td></td>
<td>• Disclosures relating to classification and valuation are adequate and in accordance with accounting standards.</td>
</tr>
</tbody>
</table>

3.2 Audit procedures for inventory

The following table sets out audit procedures to test year-end inventory:

<table>
<thead>
<tr>
<th>AUDIT PLAN: INVENTORY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Existence</strong></td>
</tr>
<tr>
<td><strong>Completeness</strong></td>
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</tbody>
</table>
## AUDIT PLAN: INVENTORY

### Rights and obligations
- 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.

### 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.
AUDIT PLAN: INVENTORY

- **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.

**Assertions relating to presentation and disclosure**

**Accuracy**

- 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).

**Classification and understandability**

- **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.

**Completeness, accuracy and valuation**

- **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 (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 should 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 necessary **ownership**) of inventory and in identifying obsolete, damaged or aging 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.
- Arrange 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. i.e. 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:

<table>
<thead>
<tr>
<th>AUDIT PLAN: FOLLOWING UP THE INVENTORY COUNT</th>
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<tbody>
<tr>
<td>- <strong>Trace items</strong> that were <strong>test counted</strong> to final inventory sheets.</td>
</tr>
<tr>
<td>- <strong>Observe whether all count</strong> records, including consignment inventories if they are held, have been <strong>included</strong> in final inventory sheets.</td>
</tr>
<tr>
<td>- <strong>Inspect the final inventory sheets</strong> to ensure they are <strong>consistent with</strong> count records.</td>
</tr>
</tbody>
</table>
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, i.e., 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

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 date of 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 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 (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 third party's 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.
- Auditors should 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.
- Auditors should trace items selected from the records to the physical inventory and items selected from the physical inventory to the count records.
- It will be necessary to check from the entity's inventory records to auditor's test data for the location and items to be traced at later stage.
- Performing 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, auditors need to consider at which locations attendance is appropriate, taking into account the materiality of inventory and the risk of material misstatement at different locations.
- Auditors should 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 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.
- Auditors may 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.
- In addition, auditors should 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 2

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 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.

<table>
<thead>
<tr>
<th>AUDIT PLAN: RECEIVABLES</th>
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</thead>
<tbody>
<tr>
<td>Completeness</td>
</tr>
<tr>
<td>• Agree the balance from the individual sales ledger accounts to the aged receivables' listing and vice versa.</td>
</tr>
<tr>
<td>• Match the total of the aged receivables’ listing to the sales ledger control account.</td>
</tr>
<tr>
<td>• Cast and cross-cast the aged trial balance before selecting any samples to test.</td>
</tr>
<tr>
<td>• Trace a sample of shipping documentation to sales invoices and into the sales and receivables' ledger.</td>
</tr>
<tr>
<td>• Complete the disclosure checklist to ensure that all the disclosures relevant to receivables have been made.</td>
</tr>
<tr>
<td>• Compare the gross profit percentage by product line with the previous year and industry data.</td>
</tr>
<tr>
<td>• Compare the level of prepayments to the previous year to ensure the figure is materially correct and complete.</td>
</tr>
<tr>
<td><strong>AUDIT PLAN: RECEIVABLES</strong></td>
</tr>
<tr>
<td>--------------------------------</td>
</tr>
<tr>
<td><strong>Existence</strong></td>
</tr>
<tr>
<td><strong>Rights and obligations</strong></td>
</tr>
</tbody>
</table>
| **Valuation and allocation** | • Compare receivables' turnover and receivables' days to the previous year and/or to industry data.<br>• Compare the aged analysis of receivables from the aged trial balance to the previous year.<br>• Review the adequacy of the allowance for uncollectable accounts through discussion with management.<br>• Compare the bad debt expense as a percentage of sales to the previous year and/or to industry data.<br>• Compare the allowance for uncollectable accounts as a percentage of receivables or credit sales to the previous year and/or to industry data.<br>• Examine large customer accounts individually and compare to the previous year's balances.<br>• 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.<br>• 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
- 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
- Take a sample of sales invoices and examine for proper classification into revenue accounts.

#### Accuracy
- 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
- 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
- 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
- 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
- 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
Under HKSA 505 (Clarified) External Confirmations, confirmation is the major substantive test in which the auditor will select a sample of accounts receivables’ balances from the sales ledger for confirmation.

The external confirmation is a direct written response to the auditor from a third party in order to design and perform 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
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. From an independent source (external parties,) it is a 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 than normal audit tests, 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) 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 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). 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
• 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 respond 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
• If 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
specific audit procedures | Part D Assurance engagements

- 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

4.5 Follow-up procedures

4.5.1 Doubts about the reliability of responses to confirmation requests

There is always some risk exists regardless of what form the response is obtained. 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 situation, 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

4.5.3 Exceptions

Key term

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.

Exceptions may indicate misstatements or potential misstatements in the financial statements not represent misstatements. 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:

<table>
<thead>
<tr>
<th>Reasons for exceptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>There is a <strong>dispute</strong> 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.</td>
</tr>
<tr>
<td><strong>Cut-off problems</strong> 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).</td>
</tr>
<tr>
<td>The customer may have sent the <strong>monies before</strong> the year-end, but the monies were <strong>not recorded</strong> by the entity as receipts until <strong>after</strong> the year-end. Detailed cut-off work may be required on receipts.</td>
</tr>
<tr>
<td>Monies received may have been posted to the <strong>wrong account</strong> 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.</td>
</tr>
<tr>
<td>Customers who are also suppliers may <strong>net-off balances</strong> owed and owing. Auditors should check that this is allowed.</td>
</tr>
<tr>
<td><strong>Teeming and lading, stealing monies</strong> and <strong>incorrectly posting</strong> other receipts so that no particular customer is seriously in debt is a <strong>fraud</strong> 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.</td>
</tr>
</tbody>
</table>

### 4.6 Evaluation and conclusions

HKSA 505 requires that the auditor shall evaluate 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 bad debt

The amount shown in the trade receivables in the statement of financial position would 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 aging 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.

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 External Confirmation.

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 on financial statements, and financial statements 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 financial statements 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 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 cut-off carefully.

(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

<table>
<thead>
<tr>
<th>AUDIT PLAN: BANK</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Obtain standard bank confirmations from each bank with which the entity conducted business during the audit period.</td>
</tr>
<tr>
<td>• Reperform arithmetic of bank reconciliation.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Verify contra items appearing in the cash books or bank statements with original entry.</td>
</tr>
</tbody>
</table>
• 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:

<table>
<thead>
<tr>
<th>AUDIT PLAN: TRADE PAYABLES AND ACCRUALS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Completeness</strong></td>
</tr>
<tr>
<td>• From a listing of trade payables <strong>reconcile</strong> the total to the general ledger by casting and cross-casting.</td>
</tr>
<tr>
<td>• Consider whether there could be significant unrecorded liabilities by <strong>inquiries of management</strong>; examine post year-end transactions.</td>
</tr>
<tr>
<td>• Select a sample of suppliers' statements and <strong>trace</strong> these back to the supplier's accounts.</td>
</tr>
<tr>
<td>• Examine files of unmatched purchase orders and supplier invoices for any <strong>unrecorded liabilities</strong>.</td>
</tr>
<tr>
<td>• Perform a <strong>confirmation of trade payables</strong> for a sample (see Section 6.2 for details of the trade payables' confirmation).</td>
</tr>
<tr>
<td>• Complete the <strong>disclosure checklist</strong> to ensure that all the disclosures relevant to liabilities have been made.</td>
</tr>
<tr>
<td>• Perform <strong>comparisons</strong> of the following data to check for reasonableness:</td>
</tr>
<tr>
<td>– current year balances for trade payables and accruals to the previous year.</td>
</tr>
<tr>
<td>– the amounts owed to a sample of individual suppliers in the trade payables listing to amounts owed to these suppliers in the previous year.</td>
</tr>
<tr>
<td>– the payables' turnover and payables' days to the previous year and industry data.</td>
</tr>
<tr>
<td><strong>Existence</strong></td>
</tr>
<tr>
<td>• <strong>Vouch</strong> selected amounts from the trade payables listing and accruals schedule to supporting documentation (purchase orders and suppliers' invoices and so on).</td>
</tr>
<tr>
<td>• <strong>Reconcile</strong> a selection of suppliers' statements to the relevant suppliers' accounts.</td>
</tr>
<tr>
<td>• Perform a <strong>confirmation of trade payables</strong> for a sample.</td>
</tr>
<tr>
<td>• Perform <strong>analytical procedures</strong> 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.</td>
</tr>
<tr>
<td><strong>Rights and obligations</strong></td>
</tr>
<tr>
<td>• <strong>Vouch</strong> a sample of balances to supporting documentation to obtain audit evidence on rights and obligations.</td>
</tr>
</tbody>
</table>
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:

(a) 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:

(a) **Completeness**: whether all non-current liabilities have been adequately disclosed

(b) **Accuracy**: whether interest payable has been calculated correctly and included in the correct accounting period

(c) **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.

- Ascertaint 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

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 the letter to the entity’s external legal counsel should take: 'The letter, which should be prepared by management and sent by the auditor, should request 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 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 made any impairment loss in the financial statements for litigation and claims. If no, 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

The approach to auditing provisions is similar to that for the audit of contingencies.

<table>
<thead>
<tr>
<th>AUDIT PLAN: PROVISIONS/CONTINGENCIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Obtain details of all provisions which have been included in the financial statements.</td>
</tr>
<tr>
<td>• Obtain a detailed analysis of all provisions showing opening balances, movements and closing balances.</td>
</tr>
<tr>
<td>• Determine for each material provision whether the company has a present obligation as a result of past events by:</td>
</tr>
<tr>
<td>– review of correspondence relating to the item</td>
</tr>
<tr>
<td>– discussion with the directors. Have they created a valid expectation in other parties that they will discharge the obligation?</td>
</tr>
<tr>
<td>• Determine for each material provision whether it is probable that a transfer of economic benefits will be required to settle the obligation by:</td>
</tr>
<tr>
<td>– checking whether any payments have been made in the post balance sheet period in respect of the item.</td>
</tr>
<tr>
<td>– review of correspondence with solicitors, banks, customers, insurance company and suppliers both pre and post year end.</td>
</tr>
<tr>
<td>– sending a letter to the solicitor to obtain their views (where relevant).</td>
</tr>
<tr>
<td>– discussing the position of similar past provisions with the directors. Were these provisions eventually settled?</td>
</tr>
<tr>
<td>– considering the likelihood of reimbursement.</td>
</tr>
<tr>
<td>• Recalculate all provisions made.</td>
</tr>
<tr>
<td>• Compare the amount provided with any post year end payments and with any amount paid in the past for similar items.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Consider the nature of the client's business. Would you expect to see any other provisions eg warranties?</td>
</tr>
<tr>
<td>• Consider adequacy of disclosure of provisions.</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>AUDIT PLAN: CAPITAL AND RELATED ISSUES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Share equity capital</strong></td>
</tr>
<tr>
<td>• Agree the authorised share capital with the entity’s Articles and Memorandum</td>
</tr>
<tr>
<td>• Agree any changes to authorised share capital with properly authorised resolutions.</td>
</tr>
<tr>
<td><strong>Issue of shares</strong></td>
</tr>
<tr>
<td>• Verify any issue of share capital or other changes during the year with general and board minutes.</td>
</tr>
<tr>
<td>• Ensure issue or change is within the terms of the constitution, and directors possess appropriate authority to issue shares.</td>
</tr>
<tr>
<td>• Confirm that cash or other consideration has been received or receivable(s) is included as called-up share capital not paid.</td>
</tr>
<tr>
<td><strong>Transfer of shares</strong></td>
</tr>
<tr>
<td>• Verify transfers of shares by reference to:</td>
</tr>
<tr>
<td>– correspondence</td>
</tr>
<tr>
<td>– completed and stamped transfer forms</td>
</tr>
<tr>
<td>– cancelled share certificates</td>
</tr>
<tr>
<td>– minutes of directors’ meetings</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td><strong>Dividends</strong></td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Agree dividend payments with documentary evidence such as the returned dividend warrants.</td>
</tr>
<tr>
<td>• Check that dividends do not breach the distribution legislation.</td>
</tr>
<tr>
<td>• Check that imputed tax has been accounted for to the taxation authorities and correctly treated in the financial statements.</td>
</tr>
<tr>
<td><strong>Reserves</strong></td>
</tr>
<tr>
<td>• Agree movements on reserves to supporting authority.</td>
</tr>
<tr>
<td>• Ensure that movements on reserves do not contravene the legislation and the entity’s constitution.</td>
</tr>
<tr>
<td>• Confirm that the entity can distinguish distributable reserves from those that are non-distributable.</td>
</tr>
<tr>
<td>• Ensure appropriate disclosures of movements on reserves are made in the entity’s financial statements by inspection of the financial statements.</td>
</tr>
</tbody>
</table>

## 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.

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 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; and

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:

<table>
<thead>
<tr>
<th>AUDIT PLAN: SALES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Completeness</strong></td>
</tr>
<tr>
<td><strong>Analytical procedures</strong></td>
</tr>
<tr>
<td>• Compare current year’s sales level with last year.</td>
</tr>
<tr>
<td>• Consider the effect on sales value of changes in quantities sold or products or prices.</td>
</tr>
<tr>
<td>• Check the level of goods returned, sales allowances and discounts.</td>
</tr>
<tr>
<td>• Calculate the gross profit margin and record the reasons for changes.</td>
</tr>
<tr>
<td>• Perform a detailed analysis of the gross profit margin.</td>
</tr>
<tr>
<td><strong>Vouching and tracing</strong></td>
</tr>
<tr>
<td>• Auditor could trace from goods despatch notes or till rolls to sales.</td>
</tr>
<tr>
<td>• Auditor should ensure sales invoices and despatch notes are all pre-numbered.</td>
</tr>
<tr>
<td><strong>Accuracy</strong></td>
</tr>
<tr>
<td>• Cast the additions on invoices and check the pricing calculations.</td>
</tr>
<tr>
<td>• Check calculations of discounts.</td>
</tr>
<tr>
<td>• Check any purchase tax has been added appropriately.</td>
</tr>
<tr>
<td>• Trace any debits in the sales account.</td>
</tr>
<tr>
<td>• Review reconciliations of sales ledger control account and investigate on any unusual items.</td>
</tr>
<tr>
<td><strong>Cut-off</strong></td>
</tr>
<tr>
<td>• Obtain details of the last serial numbers of despatch notes issued before the commencement of any inventory count.</td>
</tr>
<tr>
<td>• Ensure the entity has recorded all movement of inventory within the period.</td>
</tr>
<tr>
<td>• Consider the last goods received notes and despatch notes prior to and after the inventory count.</td>
</tr>
<tr>
<td>• Observe whether correct cut-off procedures are being followed in the despatch and receiving areas.</td>
</tr>
<tr>
<td>• Check invoices and credit notes are dated in the correct period.</td>
</tr>
<tr>
<td>• Check invoices and credit notes are posted to the sales ledger and general ledger in the correct period.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Review sales ledger control account around year end for unusual items.</td>
</tr>
<tr>
<td>• Review material after-date invoices, credit notes and adjustments.</td>
</tr>
<tr>
<td>• Review shipment terms for goods in transit.</td>
</tr>
<tr>
<td>• Test inventory received and sales after period-end and items in transit.</td>
</tr>
</tbody>
</table>
### AUDIT PLAN: SALES

- Examine sales transactions and supporting documentation for a period before the physical inventory and determine that goods shipped before the physical inventory 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

- Ensure sales transactions, amounts and other data have been recorded appropriately.

- Review whether entity is following HKAS, Companies Ordinance, and applies the accounting policies consistently throughout the periods i.e. consistently following revenue recognition.

- Specific review on sales with higher discount or longer repayment terms are required to ensure that the corresponding sales together with the receivables should be accounted for at fair value in accordance with HKAS 18 Revenue and HKAS 39 Financial instruments: Recognition and Measurement.

- 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.

- Checking 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.
- 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: Specific audit procedures | Part D Assurance engagements

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:

(a) goods and services should only be ordered in the correct quantity, quality and at the best terms after appropriate requisition and approval

(b) all suppliers' invoices should be examined against proper authorised purchase orders

(c) all goods and services invoiced should be properly recorded in the accounting records on a timely basis

(d) 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:

(a) 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

(b) 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

(c) Order procedures should involve tendering and receiving quotations from suppliers

(d) Sequence checks of purchase orders should be performed regularly

(e) Goods received notes and debit notes should be pre-numbered and should be sent separately to different departments

(f) Proper controls should be placed on different types of documents such as suppliers’ invoices, vouchers and purchase ledgers

(g) Budgetary techniques should be used to control all goods and services purchased

(h) 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:

<table>
<thead>
<tr>
<th>AUDIT PLAN: PURCHASES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Occurrence and completeness</strong></td>
</tr>
<tr>
<td>• Perform analytical procedures such as compare the level of purchase and expenses of this year with previous year's level.</td>
</tr>
<tr>
<td>• Consider the ratio of trade payable to purchases and the ratio of trade payable to inventory as compared with last year.</td>
</tr>
<tr>
<td>• Review the voucher register and purchase ledger for large or unusual items.</td>
</tr>
<tr>
<td>• Consider the effect on purchase value of changes in quantities purchased or products or prices.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Consider reasonableness of deductions and subsequent events.</td>
</tr>
<tr>
<td>• Testing the arithmetical accuracy ie by recalculating the amounts on suppliers' invoices, voucher register and purchase ledger.</td>
</tr>
<tr>
<td>• Consider any credit balances for purchases.</td>
</tr>
<tr>
<td>• Ensure payables are properly measured in accordance with HKAS 39.</td>
</tr>
<tr>
<td>• Perform external confirmations for trade creditors' balances.</td>
</tr>
<tr>
<td>• Perform procedures to search for unrecorded liabilities.</td>
</tr>
<tr>
<td><strong>Cut-off</strong></td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Ensure last year accruals are not expenses again in the current year.</td>
</tr>
<tr>
<td>• Check goods returned notes prior to year end.</td>
</tr>
<tr>
<td>• Review large invoices credit notes after the year end.</td>
</tr>
<tr>
<td>• Review outstanding purchase orders for purchases completed but not invoiced.</td>
</tr>
<tr>
<td>• Select goods received notes before and after year-end and check against invoices entered in purchases, inventory and creditor accounts for correct cut-off.</td>
</tr>
<tr>
<td>• Perform external confirmations for trade creditors' balances.</td>
</tr>
<tr>
<td>• 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.</td>
</tr>
<tr>
<td>• Review the control account around the year end for unusual items.</td>
</tr>
</tbody>
</table>

14 Wages and salaries

Payroll is an area where an entity may inefficiently waste or deliberately misappropriate through fraud.

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 is 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 is 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:

<table>
<thead>
<tr>
<th>AUDIT PLAN: WAGES AND SALARIES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Occurrence</strong></td>
</tr>
<tr>
<td>• Examine personnel records, employment contracts to verify each individual remuneration.</td>
</tr>
<tr>
<td>• Attend wage payout on an irregular basis.</td>
</tr>
<tr>
<td>• Investigate long outstanding payroll checks.</td>
</tr>
<tr>
<td>• Inspect tax records.</td>
</tr>
<tr>
<td>• Confirm with HR department.</td>
</tr>
<tr>
<td>• Conduct analytical procedures such as comparing payroll expenses with prior years.</td>
</tr>
<tr>
<td><strong>Accuracy</strong></td>
</tr>
<tr>
<td>• Check calculations of remuneration by re-computing.</td>
</tr>
<tr>
<td>• Check any deductions from salary such as pension or MPF.</td>
</tr>
<tr>
<td><strong>Completeness</strong></td>
</tr>
<tr>
<td>• Cast check payroll records.</td>
</tr>
<tr>
<td>• Test commission expenses.</td>
</tr>
<tr>
<td>• Scrutinise payroll and investigate unusual items.</td>
</tr>
<tr>
<td>• Agree net pay to payroll ledger.</td>
</tr>
</tbody>
</table>
Self-test question 3

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)
Topic recap

- Key areas when testing **tangible non-current assets** are:
  - confirmation of ownership
  - inspection of non-current assets
  - valuation by third parties
  - adequacy of depreciation rates
- Key assertions for intangible non-current assets are **existence and valuation**.
- The key assertions relating to **inventory** are:
  - existence
  - completeness
  - rights and obligations
  - valuation
  - cut-off
- 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 inventory and work-in-progress.
- 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.
- Receivables are usually audited using a combination of **tests of detail** and **analytical procedures**.
- **Existence**, **completeness** and **valuation** are key assertions relating to the audit of receivables.
- A **confirmation of receivables** is a major procedure, usually achieved by **direct contact** with customers. There are two methods of confirmation: **positive** and **negative**.
- **Bank balances** are usually **confirmed directly** with the bank in question.
- The **bank confirmation letter** can be used to ask a variety of questions, including queries about outstanding interests, contingent liabilities and guarantees.
- **Cash balances** should be verified if they are **material** or **irregularities** are suspected.
- The largest figure in **current liabilities** will normally be **trade payables** which are generally audited by comparison of **suppliers’ statements** with **purchase ledger accounts**.
- Non-current liabilities are usually authorised by the board and should be well documented.
- The accounting treatments for impairment losses and contingencies are complex and involve judgment and this can make them difficult to audit.
- The main concern with **share capital and reserves** is that the entity has complied with the law.
- For verification of sales, auditors have to be aware of special sales and consignment sales.
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, the auditor should 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 license.

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

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 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 their 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 3

(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 as to 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 HKSA
(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.
(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.
Bank loan

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

Describe the relevant substantive audit procedures to test the $10,000,000 bank loan outstanding at the year-end.

(5 marks)

HKICPA September 2006 (amended)
chapter 14
Using the work of others

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:

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<th>Competency</th>
<th>Description</th>
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<td>2.10</td>
<td>Audit evidence</td>
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<tr>
<td>2</td>
<td>2.10.05</td>
<td>Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations</td>
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<td>2</td>
<td>2.11</td>
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<tr>
<td></td>
<td>2.11.02</td>
<td>Discuss why auditors may rely on the work of others, including internal audit, experts and service organisations</td>
</tr>
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</table>
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**

An **auditor's expert** is an individual or entity possessing special skill, knowledge and experience in a particular field other than accounting and 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 entity 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.

The following list of examples is given by HKSA 620 (Clarified) *Using the Work of an Auditor's Expert* of the audit evidence which might be obtained from the use of an auditor's expert:

(a) **Valuing certain types of assets**, eg 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

1.2 Determining the need to use the work of an auditor's expert

HKSA 620 (Clarified) requires that auditor shall determine whether to use the work of an auditor's expert due to 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 competent 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
1.3 Effect of management's expert on the use of auditor's expert

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 objectivity of 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 (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 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 auditor's 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 audit'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 examples, 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:

(a) 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
(b) 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:

(a) the relevance of the auditor's expert's competence to be applied in other areas in the audit
(b) 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 (Clarified) requires that the auditor shall evaluate the adequacy of the auditors expert's work based on the following:

<table>
<thead>
<tr>
<th>Factors</th>
<th>Details</th>
</tr>
</thead>
</table>
| The relevance and reasonableness of auditor's expert's findings or conclusions | Auditor can use specific procedures such as:
  • inquire of auditor's expert
  • review working papers and reports of auditor's expert
  • discuss with another expert
  • discuss with management the report of the auditor's expert
  • other procedures such as observation of expert's work or confirming with third parties
  The factors that the auditor should consider for evaluation are whether:
    • 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 has taken into account of 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 | 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. |
| The relevance, completeness and accuracy of the source data used by the auditor's expert | The auditor shall verify the origin of the data and review the data for completeness and internal consistency. |

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 opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.

The auditor shall **not refer** to the work of an auditor's expert in an auditor when an unmodified opinion is expressed. Unless required by law or regulations, the auditor shall not reduce his responsibility for the auditor's opinion.

### 1.6 Management's expert

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.

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**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 20Y0. On 1 July 2010, 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 20Y0 after taking into account of depreciation up to 30 June 20Y0. 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)*
## 2 Service organisations

### Topic highlights

A **service organisation** provides outsourced services to another entity. This raises particular concerns for the auditor.

### Key term

A **service organisation** is an organisation that provides services to another entity.

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 auditor should consider how an entity's use of a service organisation affects the entity's accounting and internal control so as to assess the risk of material misstatement and to design and perform further audit procedures'.

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
- Other finance functions
- Management of assets
- Undertaking or making arrangements for 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.

Which service is provided will have a direct impact on the audit requirements.

### 2.1 Considerations of the entity auditor

The HKSA states, 'the auditor should determine the significance of service organisation activities to the entity and the **relevance to the audit**'. The auditor should obtain **sufficient and appropriate audit evidence** to understand the accounting and internal control systems in order to assess the controls risk and to design further audit procedures to response to the assessed risks.

Further, the standard requires the auditor to understand the terms of the agreement between the service organisation and the user entity. The following should be obtained and documented:

(a) **The contractual terms** under which relevant activities by service organisations are made

(b) The processes in place for the user entity to **monitor** the activities so as to ensure that it complies with its **fiduciary and other legal responsibilities**
The HKSA requires the auditor to establish the following:

(a) Whether the terms of the agreement contain sufficient specification of the information to be provided to the user entity and responsibilities for initiating transactions relating to the activity undertaken by the service organisation

(b) How accounting records relating to relevant activities are prepared

(c) Whether the user entity has a right of access to accounting records prepared by the service organisation concerning the activities undertaken, and relevant underlying information held by it, and the conditions in which such access may be sought

(d) Whether the terms take sufficient account of any applicable requirements of regulatory bodies concerning the form of records to be maintained, or access to them

(e) The nature of relevant performance standards

(f) The way in which the user entity monitors performance of relevant activities and the extent to which its monitoring process relies on controls operated by the service organisation

(g) Whether the service organisation has agreed to indemnify the user entity in the event of a performance failure

(h) Whether the contractual terms permit the user entity auditors access to sources of audit evidence including accounting records of the user entity and the information necessary for the conduct of the audit

In obtaining an understanding of the entity, the auditor will also consider these factors:

(a) The nature of the services provided by the service organisation

(b) The terms of contract and relationship between the entity and the service organisation

(c) The extent to which the entity’s accounting and internal control systems interact with the systems at the service organisation

(d) The entity’s internal controls relevant to the service organisation activities

(e) The service organisation’s capability and financial strength, including the possible effect of the failure of the service organisation on the entity

(f) Information about the service organisation such as that reflected in user and technical manuals

(g) Information available on general controls and computer systems controls relevant to the entity’s applications

The entity auditor should also consider the existence of third-party reports from service organisation auditors, internal auditors, or regulatory agencies as a means of providing information about the accounting and internal control systems of the service organisation and about its operation and effectiveness.

2.2 Obtaining audit evidence

The HKSA states that

'Based on their understanding of the aspects of the user entity’s accounting system and control environment relating to relevant activities, user entity auditors should:

(a) Assess whether sufficient appropriate audit evidence concerning the relevant financial statement assertions is available from records held at the user entity; and if not

(b) Determine effective procedures to obtain evidence necessary for the audit, either by direct access to records kept by service organisations or through information obtained from the service organisations or their auditors.'
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

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.
A service organisation provides services to another organisation. There may be special circumstances for an auditor when the entity makes use of a service organisation.

External auditors may make use of an expert when carrying out audit procedures.

The auditor must ensure that the work of the expert can be relied upon if it is to contribute to the formation of the audit opinion.
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 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.
Exam practice

Auditor's expert

18 minutes

You find yourself as the auditor facing the following situations.

(a) ‘The useful life of each oil platform is assessed annually on factors such as weather conditions and the period over which it is estimated that oil will be extracted.’ You are auditing the useful lives of the oil platforms. (5 marks)

(b) ‘Piles of copper and brass, which can be distinguished with a simple acid test, have been mixed up.’ You are attending the inventory count. (5 marks)

Required

Explain whether it is necessary to use the work of an auditor’s expert in these situations. Where relevant, you should describe alternative procedures. (Total = 10 marks)
chapter 15

Accounting estimates, opening balances and comparatives

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</table>

Learning focus

When an estimate is involved, the use of judgment means the level of risk is higher. Be alert to 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.
In this chapter you will cover the following learning outcomes:

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<th>Competency level</th>
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<tbody>
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<td>2.09</td>
<td>Audit procedures</td>
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<tr>
<td>2.09.10</td>
<td>Discuss the audit problems and identify procedures for the audit of:</td>
</tr>
<tr>
<td>2.09.10.01</td>
<td>Accounting estimates</td>
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<tr>
<td>2.09.10.02</td>
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<td>2.09.10.04</td>
<td>Comparatives</td>
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</table>
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 (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
An accounting estimate is an approximation of a monetary amount in the absence of a precise means of measurement.

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 instrument, which are not traded in an active and open market
- Share-based payments
- Property or equipment held for disposal
- Deferred tax

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.
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:

<table>
<thead>
<tr>
<th>Examples of low estimation uncertainty</th>
<th>Examples of high estimation uncertainty</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Relate to entities that are <strong>not</strong> engaged in <strong>complex</strong> business activities</td>
<td>• Accounting estimates relating to the outcome of litigation</td>
</tr>
</tbody>
</table>
| • Accounting estimates are frequently **updated** due to routine transactions | • Fair values accounting estimates for:
| • The method of measurement of the fair value accounting estimates based on applicable financial reporting framework is **simple** and can be applied easily | – **derivative financial instruments** not publicly traded |
| • The model used to measure the fair value accounting estimates is **well-known** or generally accepted | – highly **specialised entity-developed** model is used or 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 estimates whether there are possibilities of a number of outcome scenarios
(c) whether management monitors the outcome of accounting estimate 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

The auditor should obtain sufficient and appropriate audit evidence in regard to the 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 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, auditors 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. Auditors 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 (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

(b) method used by management for making the accounting estimates are appropriate and have been applied consistently or whether changes, if made are appropriate as compared to prior period

#### 1.5.1 Selection of procedures to perform

HKSA 540 (Clarified) requires the auditor shall 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

(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) **Testing 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) **Developing a point estimate or a range** (see key term below) to evaluate whether management's point estimate may be an appropriate treatment. For example:

(i) An accounting estimate is not derived from the entity's routine processing of data

(ii) From previous experience, the 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 affect the 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.

(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 term

**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.

**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

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.

1.7 Indications of possible management bias

**Key term**

**Management bias** is a lack of neutrality by management in the preparation of information.

During the process in 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 necessary 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.

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 in regarding the opening balances.

Key term
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.

2.1 Auditor’s objectives in respect of opening balance
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:
(a) opening balances contain misstatements that materially affect the current period’s financial statements
(b) appropriate accounting policies reflected in the opening balances have been consistently applied the current period’s financial statements
(c) 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 balance

The following flow chart shows the audit procedures on opening balances required by HKSA 510 (Clarified):

**Audit procedures on opening balance under HKSA 510**

**Obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period’s financial statements**

**Review documents:**
- Read the most recent financial statements
- Read the predecessor auditor’s report; and
- Read any other documents

**Correctly brought forward:**
- Whether prior period’s closing balances have been correctly brought forward to the current period

**Application of appropriate accounting policies:**
- Whether the opening balances reflect the application of appropriate accounting policies
- Whether accounting policies have been consistently applied
- Whether changes in accounting policies have been accounted and disclosed

**If prior year financial statements were audited:**
- Review the predecessor auditor’s working papers
- Auditor should consider the professional competence and independence of predecessor auditor

**Current period evidence:**
- Evaluate whether audit procedures performed in the current period provide evidence on opening balance or perform other specific procedures (see Section 2.3)

**If prior year financial statements were not audited:**
- The incoming auditor should state in the auditor’s report that the corresponding figures are unaudited
2.3 Specific audit procedures

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.

2.4 Material misstatements in opening balances

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 (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

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 2011 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 2010. 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 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 2010, 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 2011 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 2010. 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 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 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 2010 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 2010 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.

Self-test question 1

You are the audit manager of a CPA firm, ABC & Co. You are responsible for the audit of the financial statements of a new entity, Opening Balance Limited ('OBL'), for the year ended 31 December 20Y0.

OBL is incorporated in Hong Kong.

The previous auditor of OBL has expressed a modified opinion on the financial statements of OBL for the year ended 31 December 20X9, stating that the management inappropriately classified a current liability of HK$40,000,000 as a non-current liability and that there was fundamental uncertainty on OBL's ability to continue as a going concern.

Included in the balance of non-current bank loans in OBL's statement of financial position as at 31 December 20X9 was a loan of HK$40,000,000 due for repayment on 30 September 20Y3. During the year ended 31 December 20X9, OBL failed to pay interests of HK$2,000,000 for the loan. According to the loan agreement, the bank has a right to demand immediate repayment for the total loan. However, the bank did not do so; nor did it explicitly extend the due date for the interest payment. Before OBL approved its financial statements for the year ended 31 December 20X9, OBL was able to obtain equity finance of HK$5,000,000 from new investors. As a result, OBL paid the overdue interests in April 20Y0, as well as the interest due during the year ended 31 December 20Y0.

As at 31 December 20Y0, total equity of OBL amounted to HK$20,000,000, and total non-current bank loans was HK$40,000,000. The non-current bank loan was secured by plant and equipment of OBL and corporate guarantee from a wholly-owned subsidiary of the controlling shareholder of OBL. The new equity finance changed the net current liability position of OBL in 31 December 20X9 of HK$2,000,000 to a net current asset position in 31 December 20Y0 of HK$1,000,000.
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 (Clarified) Comparative Information – Corresponding Figures and Comparative Financial Statements establishes standards and provides guidance on the auditors’ responsibilities regarding comparatives.

The auditor should determine whether the comparatives comply in all material respects with the financial reporting framework applicable to the financial statements being audited.

Key terms

**Corresponding figures** are amounts and other disclosures for the preceding 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’). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.

**Comparative financial statements** are amounts and other disclosures of the preceding period included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

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

The auditor should obtain sufficient appropriate audit evidence that the comparative financial statements meet the requirements of 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 the 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 shall obtain specific written representations regarding any restatement made to correct a material misstatement in prior period financial statements 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:

<table>
<thead>
<tr>
<th>Resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework</th>
<th>The auditor's opinion on the current period need not refer the previous modification.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unresolved</td>
<td>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).</td>
</tr>
</tbody>
</table>
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 2009 and HK$2,500,000 in 2010, property, plant and equipment should be reduced by accumulated depreciation of HK$1,500,000 in 2009 and HK HK$2,700,000 in 2010, and the accumulated loss should be increased by HK$1,500,000 in 2009 and HK$2,700,000 in 20X0.

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 2010, 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.

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 2009, 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 2009. Our audit opinion on the financial statements for the period ended 31 December 2009 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 2010, 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:

(a) the auditor has obtained audit evidence that a material misstatement exists in the prior period financial statements
(b) an unmodified opinion has been previously issued
(c) the corresponding figures have not been properly restated or appropriate disclosures have been made

Alternatively, the auditor may include an emphasis of matter paragraph when:

(a) the prior period financial statements that are misstated have not been amended
(b) the auditor's report has not been reissued, but
(c) the corresponding figures have been properly restated or appropriate disclosures have been made in the current period financial statements.

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 report issued by the predecessor auditor and if the report was modified, the reasons why
   (iii) the date of that report
The auditor shall obtain **sufficient and appropriate** audit evidence in regarding the accounting estimates.

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.

The auditor shall determine whether the accounting estimate has been made in accordance with the requirements of the applicable financial reporting framework and the method used by management for making the accounting estimates are appropriate and have been applied consistently or whether changes, if made are appropriate as compared to prior period.

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

Some accounting estimates involve **low estimation uncertainty** but alternatively some may involve **high estimation uncertainty**.

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**.

For auditors, the determination of **fair value** will generally be more difficult than determining historical cost.

The auditor's point estimate or auditor's range is the amount, or range of amounts respectively, derived from audit evidence for use in evaluate management's point estimate.

The auditor shall identify whether there are **indicators of possible management bias** when reviewing the judgement and decisions made by management in the making of accounting estimates during the audit.

The auditor shall obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period’s financial statements and appropriate accounting policies reflected in the opening balances have been consistently applied the current period’s financial statements.

The auditors’ responsibilities for **comparatives** vary depending on whether they are corresponding figures or comparative financial statements.
Answer 1

What are ABC & Co’s responsibilities regarding the opening balances of OBL?

Since it is an initial audit engagement, ABC & Co will not have previously obtained audit evidence supporting the opening balances for OBL’s financial statements for the year ended 31 December 20Y0.

In accordance with HKSA 510 (Clarified) Initial Engagement – Opening Balances, ABC & Co should obtain sufficient appropriate audit evidence that:

- the opening balances do not contain misstatements that materially affect the current period’s financial statements
- the prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, have been restated
- appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed.

What procedures ABC & Co should perform regarding the opening balances of OBL?

Review the work of the predecessor auditor

In this case, OBL’s prior period financial statements had been audited. Therefore, ABC & Co:

- may be able to obtain sufficient appropriate audit evidence regarding opening balances by reviewing the predecessor auditor’s working papers
- would also consider the professional competence and independence of the predecessor auditor.

Prior to communicating with the predecessor auditor, ABC & Co will need to consider the Code of Ethics for Professional Accountants.

Correction of misstatements

In this case, the predecessor auditors expressed a modified opinion on the financial statements of OBL for the year ended 31 December 20X9, stating that the management had inappropriately classified a current liability of HK$40,000,000 as a non-current liability and that there was fundamental uncertainty on OBL’s ability to continue as a going concern.

ABC & Co should pay particular attention in the current period to the matters which resulted in the modification.

For the alleged inappropriately classification of a current liability of HK$40,000,000 as non-current liability, ABC & Co should exercise independent judgment on whether the loan had been inappropriately classified in accordance with the relevant accounting standards.

If ABC & Co agrees with the predecessor auditor that the loan was inappropriately classified as long-term liabilities, ABC & Co should request OBL to correct the material prior period error in accordance with the relevant accounting standards, and consider whether appropriate disclosures for the correction are made in OBL’s financial statements for the year ended 31 December 20Y0.

ABC & Co should also consider whether it is appropriate for OBL to classify the loan as non-current at 31 December 20Y0.

The issue of going concern in prior period financial statements will not likely affect the current period’s financial statements since ABC & Co have to assess the use of going concern on the basis of the existing conditions.
Assessment of accounting policies used

ABC & Co will need to consider whether opening balances reflect the application of appropriate accounting policies and that those policies are consistently applied in the current period's financial statements.

When there are any changes in the accounting policies or application thereof, ABC & Co should consider whether they are appropriate and properly accounted for and adequately presented and disclosed.

What are ABC & Co's responsibilities regarding the comparatives (in the form of corresponding figures) of OBL?

ABC & Co assumes audit responsibility for the corresponding figures only in the context of the financial statements as a whole. ABC & Co is not required to re-audit the financial statements of the preceding period.

What procedures ABC & Co should perform regarding the comparatives of OBL?

ABC & Co should read the preceding period's financial statements and, using the knowledge gained during the current audit, considers whether they have been properly reflected as corresponding figures in the current period's financial statements.

ABC & Co should evaluate whether the corresponding figures meet the requirements of the applicable financial reporting framework. For this purpose, ABC & Co should evaluate whether:

- accounting policies used for the corresponding figures are consistent with those of the current period
- corresponding figures agree with the amounts and other disclosures presented in the prior period
- where applicable, appropriate adjustments and/or disclosures have been made.

If the auditor becomes aware of a possible material misstatement in the corresponding figures when performing the current period audit, the auditor performs such additional audit procedures as are appropriate in the circumstances. This may include consider the guidance in HKSA 560 (Clarified), Subsequent Events and the guidance on reporting in HKSA 710 (Clarified).
Exam practice

XYZ and KLM

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
chapter 16

Overall audit review and finalisation

**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:

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<th>Audit procedures</th>
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</thead>
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<td>Discuss the audit procedures and identify procedures for the audit of:</td>
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<td></td>
<td>2.09.10.05</td>
<td>Related party transactions</td>
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<td>2.12</td>
<td>Completion procedures</td>
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<td></td>
<td>2.12.01</td>
<td>Explain the purpose of, and the procedures to be used in:</td>
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<td>2.12.01.01</td>
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<td>Review of other published information</td>
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<td>2.12.02</td>
<td>Explain the procedures required to identify and audit related party transactions</td>
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<td></td>
<td>2.12.03</td>
<td>Explain the need to evaluate misstatements identified during the audit</td>
</tr>
<tr>
<td></td>
<td>2.12.04</td>
<td>Explain the following up on illegal acts or fraud found while performing an audit</td>
</tr>
<tr>
<td></td>
<td>2.13</td>
<td>Reporting</td>
</tr>
<tr>
<td></td>
<td>2.13.02</td>
<td>Explain the requirement for an auditor to report to management or those charged with governance</td>
</tr>
</tbody>
</table>
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.

1.1 Objectives of the auditor

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 properly 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 financial statement.

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 of 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 only be at or later than the date of the auditor's report but also be at, or later than the date the auditor's report 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 require 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:

<table>
<thead>
<tr>
<th>Adjusting events</th>
<th>Non-adjusting events</th>
</tr>
</thead>
<tbody>
<tr>
<td>Settlement of a court case</td>
<td>Dividends declared after the year-end</td>
</tr>
<tr>
<td>Sale of inventory after year-end providing evidence of its net realisable value at year-end</td>
<td>Fire causing destruction of major plant</td>
</tr>
<tr>
<td>Fraud or error showing the financial statements are incorrect</td>
<td>Announcement of a major restructuring or acquisition of another enterprise</td>
</tr>
<tr>
<td>Declaration of bankruptcy due to the deteriorating financial condition of a customer with a large outstanding receivable balance</td>
<td>Decline in market value of securities held for temporary investment or resale</td>
</tr>
<tr>
<td>Subsequent collection of a large accounts receivable which had appeared doubtful of collection at the date of the financial statements</td>
<td>Disposal after the date of the financial statements of a large portion of the entity’s productive assets</td>
</tr>
</tbody>
</table>

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.

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 affect 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.

<table>
<thead>
<tr>
<th>Audit procedures to test subsequent events</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inquiries of management or those charged with governance</strong></td>
</tr>
<tr>
<td>Confirm status of items accounted for using preliminary or inconclusive data or unusual adjustments.</td>
</tr>
<tr>
<td>Investigate whether there are any new commitments, borrowings or guarantees.</td>
</tr>
<tr>
<td>Investigate whether there have been any:</td>
</tr>
<tr>
<td>• sales or destruction of non-current assets</td>
</tr>
<tr>
<td>• issues of shares/debentures or changes in business structure</td>
</tr>
<tr>
<td>• developments involving high risk areas, provisions and contingencies</td>
</tr>
<tr>
<td>• unusual accounting adjustments</td>
</tr>
<tr>
<td>• major events (eg going concern problems) affecting appropriateness of accounting policies for estimates</td>
</tr>
<tr>
<td>• litigation or claims to indicate potential contingent liabilities</td>
</tr>
<tr>
<td>• significant changes in the assets or capital structure of the entity</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other procedures</th>
<th>Review management procedures for identifying subsequent events to ensure that management are aware of the risks.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perform procedures which usually form part of the verification of year-end account balances. These procedures include <strong>cut-off and valuation tests</strong> of various balances and related transactions.</td>
<td></td>
</tr>
<tr>
<td>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.</td>
<td></td>
</tr>
</tbody>
</table>
### 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.

(a) 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.
(b) 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 2010, 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 2010, failed to comply with the Hong Kong Companies Ordinance.

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.

Self-test question 1
Consider each of the following independent and material situations. In each case:

- The date of the financial statements is 30 September 20Y0.
- The date of the auditor's report was dated on 30 December 20Y0.
- The financial statements and the auditor's report were mailed to the members on 10 January 20Y1.
- The general meeting to approve the financial statements was held on 30 January 20Y1.

(a) Your client, MM Mining, owns a mineral exploration licence in Central China. On 30 September 20Y0, this licence was valued by an independent expert at HK$50m. This valuation is recognised in the financial statements. On 20 December 20Y0, a claim was being lodged under the new government legislation against MM Mining for returning property back to its original owners. The property claimed includes the land covered by the exploration licence. If the claim is successful the exploration licence will be worthless.

(b) Same facts as in (a) but MM Mining receives the notice on 5 January 20Y1.

(c) Your client, BF Limited, derives approximately 10 per cent of revenues from selling aviary supplies to city-based bird breeders. A government report, leaked to the press and reported in the media on 15 October 20Y0, recommends that strict limits be placed on the number of birds allowed to be kept in suburban areas. BF Limited estimates that if the recommendations are enacted, about 70 per cent of its customers will have to cut their flocks by 50 per cent or more. This would affect future sales.

(d) Your client, GP Limited, made an out-of-court settlement on 1 December 20Y0 of $300,000. The settlement was in relation to a litigation case dating back to 20X3. A provision of HK$150,000 has been recorded in the financial statements since the year ended 30 September 20X8.

(e) Same facts as in (d), except that the settlement was made on 14 January 20Y1 and the management of GP refused to revise the financial statements.

(f) On 6 January 20Y1, you discovered a debtor of your client, CP Limited, was placed in provisional liquidation on 10 October 20Y0. The debtor owed HK$600,000 as at 30 September 20Y0. A specific provision of HK$300,000 of this amount was made at this date. Based on very preliminary information the likely payout to unsecured creditors is zero.
Required

For each of the above events (a) to (f), select an appropriate action [from (i) to (v)] for the situation from the alternatives listed below and justify your response:

(i) Adjust the financial statements for the year ended 30 September 20Y0.
(ii) Disclose the information in the notes to the financial statements for the year ended 30 September 20Y0.
(iii) Request the entity to amend the financial statements for the year ended 30 September 20Y0 and plan to issue a new auditor’s report.
(iv) Request the entity to revise the financial statements for the year ended 30 September 20Y0 and plan to issue a new auditor’s report.
(v) No action is required.

(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

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 or has no realistic alternative. 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 (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 (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

<table>
<thead>
<tr>
<th>Financial</th>
<th>Operating</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Net liability or net current liability position</td>
<td>• Management intentions to liquidate or cease operations</td>
<td>• Non-compliance with capital or other statutory requirements</td>
</tr>
<tr>
<td>• Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment</td>
<td>• Loss of key management without replacement</td>
<td>• Pending legal or regulatory proceedings against the entity</td>
</tr>
<tr>
<td>• Excessive reliance on short-term borrowings to finance long-term assets</td>
<td>• Loss of a major market, key customers, licence, or principal suppliers</td>
<td>• Changes in law or regulations that may adversely affect the entity</td>
</tr>
<tr>
<td>• Withdrawal of financial support by creditors, holding entity and shareholders</td>
<td>• Labour difficulties</td>
<td>• Uninsured or under-insured catastrophes when they occur</td>
</tr>
<tr>
<td>• Negative operating cash flows</td>
<td>• Shortages of important supplies</td>
<td></td>
</tr>
<tr>
<td>• Adverse key financial ratios</td>
<td>• Emergence of a highly successful competitor</td>
<td></td>
</tr>
<tr>
<td>• Substantial operating losses or significant deterioration in the value of assets used to generate cash flows</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Arrears or discontinuance of dividends</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Inability to pay creditors on due dates</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Inability to comply with terms of loan agreements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Change from credit to cash-on-delivery transactions with suppliers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Inability to obtain financing for essential new product development or other essential investments</td>
<td></td>
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</tr>
</tbody>
</table>

### 2.3 Management's responsibilities

It is management's responsibility to make assessment on 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 does not have to carry out specific procedures to identify problems which may occur after the period covered by management's assessment.

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 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:
2.4 Auditor's risk assessment procedures

When performing risk assessment procedures as required by HKSA 315 (Clarified), 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.

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

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).

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 auditor 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

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 from shareholders, creditors or related parties
- Reviewing terms of debenture or bank loans
- 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 (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
- the entity may be unable to realize 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 December 31, 2010 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 2011. 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 realize 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 2010 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 qualified opinion**

The Company’s financing arrangements expired and amounts outstanding are payable on 31 December 2010. 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 realize 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 of 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 2010, 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 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 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:

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Impact on auditor's report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Going concern assumption appropriate but material</td>
<td>Unmodified opinion and emphasis of matter paragraph</td>
</tr>
<tr>
<td>uncertainty which is adequately described and disclosed</td>
<td></td>
</tr>
<tr>
<td>Going concern assumption appropriate but material uncertainty which is not adequately disclosed</td>
<td>Qualified or adverse opinion</td>
</tr>
<tr>
<td>Use of going concern assumption inappropriate</td>
<td>Adverse opinion</td>
</tr>
<tr>
<td>Management unwilling to make or extend its assessment</td>
<td>Qualified or disclaimer of opinion</td>
</tr>
</tbody>
</table>
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:

(a) whether the events or conditions constitute a material uncertainty

(b) whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements

(c) the adequacy of related disclosures

Self-test question 2

OPR is a large private entity that manufactures steel and other products used in the construction of toll roads in China. During the course of the December 20Y0 audit of OPR, a prominent Hong Kong based infrastructure group announced that it intends to postpone indefinitely a major proposed toll road project in Southern China. You know that OPR's projections include a major share of the work expected to flow from this project.

The entity has already been experiencing some cash flow difficulties, although this is not unusual in the industry. Management has recently fully extended their overdraft facility in order to pay day-to-day expenses like wages and salaries. The audit partner is concerned that the entity may be facing going concern problems, but the chief executive officer maintains that future capital expenditure can be cut back to alleviate the going concern issue. In addition, surplus assets can be sold and long-term debt rescheduled if necessary.

Required

(a) The audit partner has asked you to investigate further the Chief Executive Officer claims. Prepare a list outlining the information and analysis you require the management to provide to you to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements.

(b) What are the possible mitigating factors that the chief executive officer has not yet mentioned?

(c) The managing director vehemently believes that, since the entity is privately held and all the shareholders are involved in the business, no disclosure of the entity's potential going concern problems is necessary. Provide a response to the Chief Executive Officer comments.

(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 (Clarified) *Written Representations* provides guidance to auditors in this area. The objectives of the auditor are described below:

(a) To obtain written representations that management believes that it has fulfilled the fundamental responsibilities that constitute the premise on which an audit is conducted

(b) To support other audit evidence relevant to the financial statements if determined 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

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) *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements* requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance to evidence the following:

(a) *Acknowledgement for 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) *Consideration of Laws and Regulations in an Audit of Financial Statements* 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.*

HKSA 450 (Clarified) *Evaluation of Misstatements Identified During the Audit* requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their *belief in the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole.*

HKSA 501 (Clarified) *Audit Evidence – Specific Considerations for Selected Items* requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their *knowledge of actual or possible litigation and claims whose*
effects should be considered when preparing the financial statements and disclosure has been made to the auditor.

HKSA 540 (Clarified) Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their belief of reasonableness of significant assumptions used in making accounting estimates.

HKSA 550 (Clarified) Related Parties requires that the auditor shall obtain written representations from management and, where appropriate, those charged with governance of their:

(a) disclosure to the auditor 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 appropriated accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

HKSA 560 (Clarified) Subsequent Events 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 and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

HKSA 570 (Clarified) Going Concern 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) Comparative Information – Corresponding Figures and Comparative Financial Statements requires that the auditor shall:

(a) Request written representations for all periods referred to in the auditor's opinion

(b) Obtain specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.

3.3 Other written representations

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

The written representations shall be in the form of a representation letter addressed to the auditor. The management representation letter should:

• be addressed to the auditors
• be appropriately dated (the day the financial statements are approved)
• 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

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 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 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 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 trade debtor is not a substitute for the same evidence obtained by trade receivable confirmation

3.7 Written representations not provided

If management refuses to provide representations that 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 to rely 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

State the circumstances set out in HKSA 580 (Clarified) Written Representations requiring auditors to obtain written representations from management as part of the process of seeking audit evidence and explain the reason for each circumstance.

(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 (ie 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 joint control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity or is a member of the key management personnel of the reporting entity or of a parent of 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)
      – joint ventures or being associates
      – owners who are close family members
      – common key management
      – ex-employee

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 the 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 relation 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 by management 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

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 (Clarified) 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

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

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 that 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 and 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
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 (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 of 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
In forming an opinion on the financial statements the auditor shall 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 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

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 of a CPA firm, Chao & Co. You are currently in charge of the audit of the financial statements of a manufacturing and trading entity in Hong Kong, Coutier Limited. The entity manufactures their own brand named handbags.

During the audit of the financial statements for the year ended 31 December 20Y0, you learnt from one of the team staff that the products of Coutier Limited were being sold in a shop in Mongkok and the owner of the shop was the wife of Coutier Limited's Sales Director. However, the information was not included in the name list of related parties.

A week before the issuance of the auditor's report, you heard from TV news that Coutier is being sued for using fake leather for its handbags.

(a) Why is it often difficult to detect related party transactions?

(b) Suggest some audit procedures you may carry out to identify the existence of transactions with related parties.

(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
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) Evaluate whether sufficient evidence is collected

(f) Evaluate 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 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.

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 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 other information?

HKSA 720 (Clarified) 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
shall **read** the other information to identify material inconsistencies if any with the audited financial statements.

### Key terms

**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

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

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). In addition, 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.

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

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 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.

If necessary, auditors have to withdraw 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 (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 term

‘Those charged with governance’ is defined by HKSA 260 (Clarified) as ‘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’. The auditor shall 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

(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 that are in both management and governance roles.

7.2 Matters to be communicated by auditors to those charged with governance

The following matters shall be communicated to those charged with governance:

<table>
<thead>
<tr>
<th>The auditor's responsibilities in relation to the financial statements audit</th>
<th>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.</th>
</tr>
</thead>
</table>
| Planned scope and timing of the audit | An overview of the planned scope and timing of the audit such as:  
  - how the auditor addresses the significant risks  
  - the auditor’s approach to internal control  
  - the application of materiality in the audit  
  - other planning matters |
| Significant findings from the audit | The auditor shall communicate the following:  
  - 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 weaknesses 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. |
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

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

Key term

**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.

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 misinterpretation a fact
- Judging wrongly an accounting estimate due to unreasonable selection and application of accounting policies

HKSA 450 (Clarified) *Evaluation in 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 (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 clearly trivial identified during the audit. It is necessary to distinguish misstatements as follows:

<table>
<thead>
<tr>
<th>Factual misstatements</th>
<th>Judgment misstatements</th>
<th>Projected misstatements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Misstatements without doubt</td>
<td>Different with management's judgment on accounting estimates and auditors consider them as unreasonable</td>
<td>Auditor's best estimate of misstatements in populations (Refer to audit sampling)</td>
</tr>
</tbody>
</table>

### 8.2 Consideration of identified misstatements as the audit progresses

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

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.

8.5 Refusal to correct misstatements

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

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

9.1 HKSA 240 (Clarified)

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 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.

9.2 HKSA 250 (Clarified)

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.
Subsequent events are events occurring between the period-end 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.

Auditors have a responsibility to review subsequent events before they sign their auditor’s report, and may have to take action if they become aware of subsequent events between the date they sign their auditor’s report and the date the financial statements are issued.

If the entity has inappropriately used the going concern assumption or a material uncertainty exists, this may impact on the auditor’s report.

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.

The auditor obtains written representations from management concerning its responsibilities and to support other audit evidence where necessary.

It can be difficult to gain audit evidence about related party transactions.

The auditor shall enquire of management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls.

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.

Towards the end of the audit process, it is usual for the auditors to undertake an overall review of the financial statements.

The auditors must perform and document an overall review of the financial statements by undertaking analytical procedures before they can reach an opinion.

Auditors should always seek to resolve inconsistencies or misstatements of fact between financial statements and other published information.

Auditors shall communicate specific matters to those charged with governance and HSKA 260 (Clarified) provides guidance to auditors in this area.

Auditors have responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.
Answers to self-test questions

Answer 1

(a) **Disclose the information in the notes to the financial statements for the year ended 30 September 20Y0**

This is an event occurring up to the date of auditor's report. The claim was lodged after the date of the financial statements and the claim is only contingent at this stage. Since the contingent event is material, it should be disclosed by way of a note to the financial statements.

(b) **Request the entity to amend the financial statements for the year ended 30 September 20Y0 and plan to issue a new auditor's report**

This is a fact discovered after the date of the auditor's report but before the issue of the financial statements.

The auditor should consider whether the statements need amendment, discuss the matter with the management and take appropriate actions.

Since the contingent event is material, the auditor should request the management to amend the financial statement to disclose the event by way of a note to the financial statements.

If management amends the financial statements, the auditor would (1) carry out the procedures necessary in the circumstances; (2) provide management with a new report on the amended financial statements; (3) date the new auditor's report not earlier than the date the amended financial statements are approved and, accordingly extend the procedures to identify event occurring up to the date of the new auditor's report.

(c) **No action is required**

This event does not relate to a condition existing at the date of the financial statements and does not affect assets and liabilities at the statement of financial position. It does not need to be addressed in the financial statements or referred to in the auditor's report. This event is more likely to be addressed, where it is necessary, somewhere else in the annual report, eg in the Chairman's Statement on business outlook.

(d) **Adjust the financial statements for the year ended 30 September 20Y0**

This is an event occurring up to the date of auditor's report which requires adjustment in the financial statements as it confirms conditions existing at the date of the financial statements.

The provision should be increased by $150,000 to reflect full settlement (ie liability at year end of $300,000).

(e) **Request the entity to revise the financial statements for the year ended 30 September 20Y0 and plan to issue a new auditor's report**

This is a fact discovered after the issue of the financial statements.

The auditor should consider whether the statements need revision, discuss the matter with management and take appropriate action.

Since the event confirms conditions existing at the date of the financial statements and the effect of the event is material, the auditor should request the management to revise the financial statement to recognise the additional provision.

In this case, the management does not revise the financial statements in circumstances where the auditor believes they need to be revised. The auditor would notify those persons.
ultimately responsible for the overall direction of the entity that action will be taken by the auditor to prevent future reliance on the auditor's report.

The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyers.

(f) Request the entity to amend the financial statements for the year ended 30 September 20Y0 and plan to issue a new auditor's report

This is a fact discovered after the date of the auditor's report but before the issue of the financial statements.

The auditor should consider whether the statements need amendment, discuss the matter with the management and take appropriate action.

Since the event confirms conditions existing at the date of the financial statements and the effect of the event is material, the auditor should request the management to revise the financial statement to recognise the additional provision.

An additional provision of HK$300,000 should be made (or the entire HK$600,000 written off).

If management amends the financial statements, the auditor would (1) carry out the procedures necessary in the circumstances; (2) provide management with a new report on the amended financial statements; (3) date the new auditor's report not earlier than the date the amended financial statements are approved and, accordingly extend the procedures to identify events occurring up to the date of the new auditor's report.

Answer 2

(a) In accordance with HKSA 570 (Clarified), when events or conditions have been identified which may cast significant doubt on OPR’s ability to continue as a going concern, the auditor should undertake the following:

(i) Review management's plans for future actions based on its going concern assessment

(ii) Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of management and other mitigating factors

(iii) Seek written representations from management regarding its plans for future action.

In this case, the auditor should:

(i) inquire of management as to OPR's plans for future action, including its future plans to cut back capital expenditure, dispose of surplus assets and reschedule long-term debts

(ii) consider whether any additional facts or information are available since the date on which management made its assessment on OPR's as a going concern

(iii) obtain sufficient appropriate audit evidence that management's plans are feasible and that the outcome of these plans will improve the situation

Audit procedures that are relevant in this regard may, among others, include the following:

(i) Analysing and discussing cash flow, profit and other relevant forecasts with management

For this purpose, the auditor should consider:

– details of capital expenditure commitments and management's assessment of how crucial these expenditures are to the viability of the entity and evidence to support the entity's ability to cut back or defer capital expenditure commitments
contracts and other documentation related to the proposed sale of surplus assets, and the management's assessment as to the feasibility of their plans to raise cash by such sales

(ii) Reviewing the terms of debentures and loan agreements. For this purpose, the auditor should consider:

- management's assessment of the feasibility of obtaining new or extended repayments terms for existing debt
- details of the existing loan agreement, the extent the facility has been utilised, and management's assessment on the possibility that extension will be granted by the lender
- details of the terms of any overdraft arrangements made by the entity
- the management's assessment of the possibility that the overdraft will exceed the facility limit

(iii) Analysing and discussing the entity's latest available interim financial statements

(iv) Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties

(b) Additional mitigating factors might include the following:

(i) Identify whether there are plans to tender for other projects to replace the toll road project in Southern China and assess the capability of the entity to win such kind of projects;

(ii) The ability to raise additional equity;

(iii) The ability to further extend the credit period being taken from suppliers; conversely, the ability to improve debt collection;

(iv) The willingness of a third party or affiliated entity to guarantee the entity's liabilities.

(c) As OPR's auditor, we should disagree with the non-disclosure of the potential going concern problems for the following reasons:

(i) Although all shareholders are involved in the business, it remains the directors' responsibility to ensure the financial statements reflect a true and fair view

(ii) Hong Kong Accounting Standards require that when management is aware in making its assessment of material uncertainties related to events or conditions which may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties should be disclosed in order that the financial statements present a true and fair view

(iii) This requirement applies equally to all types of entity and to all entities through which business is carried out, regardless of their listed or non-listed status

Answer 3

HKSA 580 (Clarified) Written Representations requires that the auditor should obtain written representations from management in the following circumstances (and for the following reasons):

That it acknowledges its responsibility for the design and implementation of internal control to prevent and detect error (because management is the responsible party with the appropriate authority for implementation decisions).

That it believes the effects of those uncorrected financial statement misstatements aggregated by the auditors during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations (because management can be made aware of the extent of uncorrected misstatements).
That it acknowledges its responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements (because management is the party responsible for the preparation of financial statements showing a true and fair view by the requirements of the Companies Ordinance).

If a written representation is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

**Answer 4**

(a) The risk that undisclosed related party transactions will not be detected by the auditors is especially high under these circumstances:

(i) Related party transactions have taken place without charge
(ii) Related party transactions are not self-evident to the auditors
(iii) Transactions are with a party whom the auditors could not reasonably be expected to know is a related party
(iv) Active steps have been taken by management to conceal either the full term transaction, or that a transaction is, in substance, with a related party
(v) The corporate structure is complex
(vi) More than one audit firm is used among different companies in a group

(b) According to HKSA 550 (Clarified) *Related Parties*, during the course of the audit, the auditor should carry out audit procedures which may identify the existence of transactions with related parties. Examples include the following:

(i) Performing detailed tests of transactions and balances
(ii) Reviewing minutes of meetings of shareholders and those charged with governance
(iii) Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognised at or near the end of the reporting period
(iv) Reviewing confirmations of loans receivable and payable and confirmation from banks. Such a review may indicate a guarantor relationship and other related party transactions
(v) Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity
(vi) Inquiring of the management all the related party transactions
(vii) Obtaining an entity’s group chart and identifying all transactions among the companies in the group chart
General Newspaper Limited is a long established local Chinese newspaper publisher with a well known brand name. However, GN’s market share is small since GN takes a traditional editorial stance that is not attractive to the general public nowadays. The newspaper market in Hong Kong is also becoming intensely competitive: free news dissimulation is available in the internet and more newspapers relying purely on advertisement income are distributed free to readers. In this environment, GN reported a loss for the first time in its history in 20X4, although the amounts of losses were not significant. GN has always been conservative in its financial management, financing most of its non-current assets by equity. However, GN is relying increasingly on bank overdrafts to finance its daily operations and its settlement of trade liabilities has slowed. As at 31 December 20X5, GN reported a net current liability of HK$2,000,000, which represented approximately 1% of GN’s capital and reserves.

For the year ended 31 December 20X5, KTT & Co is the auditor of GN’s financial statements which were to be issued by the directors of GN early the following week (on 3 May 20X6). KTT & Co has performed all the audit work and procedures necessary to comply with the auditing standards. KTT & Co considered the draft financial statements to be true and fair and prepared to issue an unqualified report after the financial statements were issued by the directors.

However, the engagement partner of KTT & Co heard on the television news that 25 of GN’s 200 staff had gone on strike, accusing GN of delaying salary payments for 2 months. The 25 staff threatened to apply to the court to liquidate GN if they had not been fully paid by mid May, and 10 of the 25 staff would resign immediately after the strike.

**Required**

Determine the appropriate actions that KTT & Co should take in accordance with the relevant auditing standards in response to these circumstances.

*HKICPA September 2006*
chapter 17

Audit reporting

Topic list

1. The auditor's report on financial statements
2. Unmodified auditor's reports
3. Modified auditor's reports
4. Emphasis of matter and other matter paragraphs
5. Special considerations – audits of financial statements prepared in accordance with special purpose frameworks
6. Special considerations – audits of single financial statements and specific elements, accounts or items

Learning focus

The auditor's report is the final product of the audit process: the final result produced by auditor who should take care about the type of reports and the wordings within the report. As stated in HKSA 200 (Clarified), the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

HKSA 700 (Clarified) Forming an Opinion and Reporting on Financial Statements, HKSA 705 (Clarified) Modifications to the Opinion in the Independent Auditor’s Report and HKSA 706 (Clarified) Emphasis of Matter Paragraphs are all effective for audits of financial statements for periods beginning on or after 15 December 2009.
In this chapter you will cover the following learning outcomes:

<table>
<thead>
<tr>
<th>2.13</th>
<th>Reporting</th>
<th>Competency level</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.13.03</td>
<td>Explain and analyse the format and content of unmodified audit reports</td>
<td>3</td>
</tr>
<tr>
<td>2.13.04</td>
<td>Explain and analyse the format and content of modified audit reports</td>
<td></td>
</tr>
</tbody>
</table>
1 The auditors' report on financial statements

Topic highlights

The auditor is required to produce an auditor's report at the end of the audit which expresses his opinion on the financial statements. The report contains a number of consistent elements so that users know the audit has been conducted according to recognised standards.

HKSA 700 (Clarified) Forming an Opinion and Reporting on Financial Statements establishes standards and provides guidance on the form and content of the auditor's report issued as a result of an audit performed by an independent auditor on the financial statements of an entity. It states that 'the auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements'.

This evaluation involves considering whether the financial statements have been prepared in accordance with an acceptable financial reporting framework being HKASs and HKFRSs and the Hong Kong Companies Ordinance. The HKSA says 'the auditor's report should contain a clear written expression of the auditor's opinion on the financial statements'.

1.1 Forming an opinion on the financial statements

In order to form that opinion, the auditor shall form an opinion on whether the financial statement are prepared, in all material respects, in accordance with the applicable financial reporting framework and shall conclude as to whether he has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

1.1.1 Sufficient appropriate audit evidence

HKSA 330 (Clarified) requires that the auditor shall conclude whether sufficient appropriate audit evidence has been obtained. The auditor shall consider whether all relevant audit evidence corroborate with the financial statement assertions. The auditor shall take into account of the following:

(a) Significance of potential misstatement in the assertion and the likelihood of having a material effect on the financial statements
(b) Effectiveness of management's responses and controls
(c) Previous years' audit experience
(d) Results of audit procedures performed
(e) Source and reliability of the available information
(f) Persuasiveness of the audit evidence
(g) Auditor's understanding of the entity and its environment, including internal controls

If auditor cannot obtain sufficient appropriate audit evidence to a material financial statement assertion, the auditor shall perform further audit procedures. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim the opinion on the financial statements.

1.1.2 Financial reporting framework

The financial reporting framework may be:

(a) a fair presentation framework – this term is used to refer to a financial reporting framework that requires compliance with the requirements of the framework:
(i) acknowledge to achieve fair presentation of the financial statements and management to provide disclosures beyond those specifically required by the framework

(ii) acknowledge that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements

(b) Compliance framework – this term is used to refer a financial reporting framework that requires compliance with the requirements of the framework but does not contain the acknowledgements as above.

The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative accounting aspects. The following are some of the requirements for evaluation:

(i) Disclosure and consistencies of significant accounting policies

(ii) Reasonableness of management's estimates

(iii) The information fairly presented in the financial statements is relevant, reliable, comparable and understandable

(iv) Effect of material transactions and events on the information conveyed in the financial statements

(v) Appropriate titles of the financial statements

(vi) Overall presentation is fair including overall structure and content of the financial statements

1.1.3 Uncorrected misstatements

The auditor's conclusion, in accordance with HKSA 450 (Clarified) Evaluation of Misstatements Identified during the Audit, whether uncorrected misstatements are material, individually or in aggregate.

1.2 Basic elements of the auditor's report

A measure of uniformity in the form and content of the auditor’s report is desirable because it helps to promote the reader's understanding and to identify unusual circumstances when they occur. The auditor's report includes the following basic elements, usually in the following layout:

<table>
<thead>
<tr>
<th>Basic elements of audit report</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Title</td>
<td>The title should indicate that the report is by an independent auditor to confirm all the relevant ethical standards regarding independence have been met. This helps readers to identify the auditor’s report and to easily distinguish it from reports that might be issued by others.</td>
</tr>
<tr>
<td>Addressee</td>
<td>The auditor's report should be addressed as required by the circumstances of the engagement, but is likely to be the shareholders or board of directors.</td>
</tr>
<tr>
<td>Introductory paragraph</td>
<td>This should identify the entity being audited, state that the financial statements have been audited, identify the financial statements being audited, specify the date and period covered by the financial statements and refer to the summary of significant accounting policies and other explanatory notes.</td>
</tr>
</tbody>
</table>
### Basic elements of audit report

<table>
<thead>
<tr>
<th>Basic elements of audit report</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of management's responsibility</strong></td>
<td>There must be a heading 'Management's [or other appropriate term] responsibility for the financial statements'. The report must contain a statement that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework. This responsibility includes designing, implementing and maintaining internal controls, selecting appropriate accounting policies and making reasonable accounting estimates. In addition, the management should determine whether the financial statements are free from material misstatement, whether due to fraud or error.</td>
</tr>
</tbody>
</table>
| **Statement of auditor's responsibility** | The auditor's report shall include a section with the heading 'Auditor's responsibility'. The report must state that the auditor is responsible for expressing an opinion on the financial statements. The report should explain that the auditor adhered to HKSAs and ethical requirements (ie the Code of Ethics) and that the auditor planned and performed the audit so as to obtain reasonable assurance that the financial statements are free from material misstatements. The report should describe the audit as including:  
- Performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements  
- The exercise of the auditor's judgment of risks of material misstatements whether due to fraud and how that assessment is made  
- Consideration of internal control relevant to the entity's preparation and fair presentation of the financial statements but not express an opinion on the effectiveness of the entity's internal control  
- The evaluation of the appropriateness of the accounting policies used, the reasonableness of estimates and the overall presentation of information in the financial statements  
- The auditor's beliefs on whether the auditor has obtained sufficient and appropriate audit evidence to provide a basis for the auditor's opinion |
<p>| <strong>Opinion paragraph</strong> | The auditor's report shall include a section with the heading 'Opinion'. If the auditor concludes that the financial statements give a true and fair view, he should express an unmodified opinion which states that the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the applicable financial reporting framework. |
| <strong>Other matters</strong> | Standards, laws or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities or the auditor's report. This can be done in a separate paragraph following the opinion. |
| <strong>Other reporting responsibilities</strong> | If the auditor is required by law to report on any other matters, this should be done in an additional paragraph below the opinion paragraph. The paragraph should be stated as 'Report on Other Legal and Regulatory Requirements' or otherwise as appropriate to the content of the section. |</p>
<table>
<thead>
<tr>
<th>Basic elements of audit report</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of the report</td>
<td>The report must be dated. This informs the reader that the auditor has considered the effect on the financial statements and on his report of events or transactions about which he became aware that occurred up to that date. The date should not be earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.</td>
</tr>
<tr>
<td>Auditor’s address</td>
<td>The location where the auditor practises must be included. This is usually the city where the auditor has his office.</td>
</tr>
<tr>
<td>Auditor’s signature</td>
<td>The report must contain the auditor’s signature, whether this is the auditor’s own name or the audit firm’s name.</td>
</tr>
</tbody>
</table>

1.3 **Other auditing standards**

Apart from complying with HKSA s in the conduct of the audit, an auditor may be required to conduct an audit in accordance with the auditing standards of a specific jurisdiction (‘other auditing standards’) as well. The auditor should ensure there is no conflict between the requirements in the other auditing standards and those in HKSA s. The auditor’s report of specific jurisdictions shall identify other auditing standards when referring to law or regulation and shall be read as reference to the other auditing standards.

1.4 **Supplementary information presented with the financial statements**

The auditor shall evaluate whether such supplementary information is clearly differentiated from the audited financial statements if supplementary information is presented with the audited financial statements.

The auditor’s opinion should cover the fact when supplementary information cannot be clearly differentiated from the audited financial statement due to its nature.

2 **Unmodified auditor's reports**

**Topic highlights**

An **unmodified opinion** should be expressed when the auditor concludes that the financial statements are prepared, in all material aspects in accordance with the applicable financial reporting framework.

An unmodified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

The auditor should review the conclusions drawn from the audit evidence obtained as the basis for the expression of his opinion on the financial information. This review and assessment involve forming an overall conclusion as to whether:

(a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied

(b) the financial information complies with the relevant legislation and regulations
(c) there is adequate disclosure of all material matters for a true and fair presentation of the financial information

The following is an example of the auditor's report on an entity incorporated in Hong Kong:

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**Independent auditor's report to the shareholders of ABC Ltd**

(Incorporated in Hong Kong with limited liability)

We have audited the financial statements of ABC Limited set out on pages 10 to 40, which comprise the statement of financial position as at 31 December 2010, and the statement of comprehensive income, statement of changes in equity or statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

**Directors' responsibility for the financial statements**

The directors are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

**Auditor's responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit 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 as to 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. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation 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. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the financial statements give a true and fair view of the state of the company's affairs as at 31 December 2010 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.

XYZ & Co.
Certified Public Accountants
Hong Kong
15 February 2011

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This section has introduced you to the standard unmodified audit report. The following section looks at how the audit report is affected when problems of varying severity arise in the audit, resulting in modified reports.
3 Modified auditor's reports

3.1 Types of modifications

HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor’s Report* and HKSA 706 (Clarified) *Emphasis of Matter Paragraphs* deals with situations where the auditor cannot issue an unmodified report.

HKSA 705 (Clarified) establishes three types of modified opinion, namely, a qualified opinion, an adverse opinion, and a disclaimer opinion.

The decision regarding which type of modified opinion is appropriate depends upon:

(a) the *materiality* of the nature of the matter giving rise to the modification

(b) the auditor's judgment about the *pervasiveness* of the effects or possible effects of the matter on the financial statements

When the auditor expects to modify the opinion in the auditor's report, he shall *communicate* with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification.

3.2 Matters that do affect the auditor's opinion

**Key terms**

A *qualified opinion* is expressed when:

(a) the auditor, having obtained sufficient appropriate audit evidence, concludes that *misstatements*, individually or in the aggregate, are material, but not pervasive, to the financial statements

(b) the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements. Or in rare cases, the auditor is not able to form an opinion on the financial statements due to the potential interaction of the multiple uncertainties and their possible cumulative effect on the financial statements.

An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

HKSA 700 (Clarified) requires that the auditor shall modify the opinion in the auditor's report in accordance with HKSA 705 (Clarified) Modifications to the Opinion in the Independent Auditor's Report if the auditor may not be able to express an unqualified opinion when either of the following circumstances exist and, in the auditor's judgment, the effect of the matter is or may be material to the financial statements:

(a) There is a limitation on the scope of the auditor's work
(b) There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures

There are different types and degrees of modified opinion:

- A limitation on scope may lead to a qualified opinion or a disclaimer of opinion
- A disagreement may lead to a qualified opinion or an adverse opinion

The following table summarises the different types of qualified opinion and we will look at the detail of each of these in turn:

**Qualification matrix**

<table>
<thead>
<tr>
<th>Nature of circumstances</th>
<th>Material but not pervasive</th>
<th>Pervasive</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Limitation on scope</strong></td>
<td>Qualified opinion (auditors disclaim an opinion on a particular aspect of the accounts which is not considered fundamental)</td>
<td>Disclaimer of opinion (auditors state they are unable to form an opinion on truth and fairness)</td>
</tr>
<tr>
<td><strong>Disagreement</strong></td>
<td>Qualified opinion (auditors express an adverse opinion on a particular aspect of the financial statements which is not considered fundamental)</td>
<td>Adverse opinion (auditors state that the financial statements do not give a true and fair view)</td>
</tr>
</tbody>
</table>

This would usually be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion (if any) in a note to the financial statements.

### 3.2.1 Limitation on scope

The scope of the auditor’s examination has been limited. When the auditor has not accumulated sufficient appropriate evidence to determine if financial statements are stated in accordance with acceptable accounting policies, not through his own fault, a limitation on scope exists.

There are two circumstances identified by the standard where there might be a limitation on scope.
(a) **Limitation on the scope of audit imposed by management**

First, a limitation on the scope of the auditor’s work may sometimes be **imposed by the entity** (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary).

The auditor shall **request that management remove the limitation**. If management refuses to remove the limitation, the auditor shall communicate the matter to **those charged with governance involved in managing entity** and determine whether it is possible to perform **alternative procedures** to obtain sufficient appropriate audit evidence.

However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would usually not accept such a limited audit engagement, unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor’s statutory duties.

If the auditor **withdraws** from the engagement, before doing so he shall **communicate to those charged with governance** any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion.

(b) **Limitation on the scope of audit imposed by circumstances**

Second, a scope limitation may be **imposed by circumstances** (for example, when the timing of the auditor’s appointment is such that the auditor is unable to observe the counting of physical inventory). It may also arise when, in the opinion of the auditor, the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances, the auditor would attempt to carry out **reasonable alternative procedures** to obtain sufficient, appropriate audit evidence to support an unqualified opinion.

The auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

The following examples are reports given under a limitation on scope.

---

**Limitation on scope – except for:**

We have audited [as for unqualified].

Management is responsible for … [as for unqualified]

**Auditor’s responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. **Except as described in the basis for qualified opinion paragraph,** we conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants........

**Basis for qualified opinion**

$X of the company’s recorded turnover comprises cash sales, over which there was no system of internal control on which we could rely for the purpose of our audit. There were no other satisfactory audit procedures that we could adopt to satisfy ourselves that the recorded turnover was free from material misstatements. **Qualified opinion arising from limitation of audit scope**

In our opinion, **except for the effects of such adjustments,** if any, as might have been determined to be necessary had we been able to satisfy ourselves as to cash sales, the financial statements give a true and fair view of the state of the company’s affairs as at 31 December 2010 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.
Limitation on scope – disclaimer of opinion
We have audited [as for unqualified].
Management is responsible for … [as for unqualified]

Auditor’s responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the limitation in the scope of our work as explained below, we conducted our audit 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 as to whether the financial statements are free from material misstatement. However, because of the matter described in the basis for disclaimer of opinion paragraph, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for disclaimer of opinion

We were initially appointed auditors on (date) which was subsequent to the end of the company’s financial year. In consequence we were unable to carry out auditing procedures necessary to obtain adequate assurance regarding the quantities and condition of inventories and work in progress, appearing in the statement of financial position at $X. There were no other satisfactory audit procedures that we could adopt to obtain sufficient evidence regarding the existence of inventories and work in progress. Accordingly, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Any adjustment to the figure may have a consequential significant effect on the profit [loss] for the year and net assets at 31 December 2010.

Disclaimer of opinion: disclaimer on view given by financial statements

Because of the significance of the matters described in the basis for disclaimer of opinion paragraph, we do not express an opinion on the financial statements as to whether they give a true and fair view of the state of the company’s affairs as at 31 December 2010 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.

3.2.2 Disagreement with management

The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. The HKSA states that if such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

Circumstances giving rise to such disagreement include the following:

(a) Departure from acceptable accounting practices where there has been a failure to comply with Accounting Standards and the auditor does not concur (ie financial statements are not prepared in accordance with HKAS).

Examples include:

(i) When entity uses replacement costs for permanent assets

(ii) When entity uses cash basis of accounting instead of the accrual basis of accounting

(iii) Accounting principles used in the financial statements have not been consistently applied (eg switch from FIFO to AVCO method in valuing inventory)

(b) Disagreement as to the facts or amounts included in the financial statements.

(c) Disagreement as to the manner or extent of disclosure of facts or amounts included in the financial statements.

(d) Failure to comply with relevant legislation or other requirements.
Look through the following examples of auditor’s reports qualified on the basis of disagreement.

**Disagreement on accounting policies – inappropriate accounting method – qualified opinion – Except for**

We have audited …[as for unqualified].
Management is responsible for … [as for unqualified].
Our responsibility is to … [as for unqualified]

**Basis for qualified opinion**

Included in debtors shown on the statement of financial position is an amount of $X due from a debtor which has ceased trading. ABC Limited has no security for this debt. On the basis that no security has been obtained and no cash has been received on the debt, in our opinion the company should make a full provision for impairment of $X, reducing profit before taxation for the year and net assets at 31 December 2010 by that amount.

**Qualified opinion arising from disagreement about accounting treatment**

In our opinion, except for the effect on the financial statements 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 2010 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.

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**Disagreement on accounting policies – inadequate disclosure – adverse opinion**

We have audited … [as for unqualified].
Management is responsible for … [as for unqualified].
Our responsibility is to… [as for unqualified].

**Basis for adverse opinion**

As more fully explained in note … to the financial statements, losses expected to arise on certain long term contracts currently in progress have not been recognised as expenses, as the directors consider that such losses should be off-set against amounts recoverable on other long-term contracts. In our opinion, the expected losses on individual contracts should be recognised as expenses immediately as required by Hong Kong Accounting Standard 11 ‘Construction Contracts’. If losses had been so recognised the effect would have been to [reduce the profit/increase the loss] before taxation for the year and reduce the gross amounts due from customers at 31 December 2010 by $X.

**Adverse opinion**

In our opinion, because of the significance of effects of the matters described in the basis for adverse opinion paragraph, the financial statements do not give a true and fair view of the state of the company’s affairs as at 31 December 2010 and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.
3.3 Form and content of the auditor's report when the opinion is modified

3.3.1 Basis for modification opinion

The auditor shall add a paragraph immediately before the opinion paragraph in addition to the specific elements required by HKSA 700 (Clarified) in the auditor's report and use the heading 'Basis for Qualified Opinion', 'Basis for Adverse Opinion', or 'Basis for Disclaimer of Opinion', as appropriate when the auditor decides to modify the opinion on the financial statements. This paragraph provides a description of the matter giving rise to the modification.

3.3.2 Quantitative disclosures

The auditor shall include in the basis for modification paragraph a description and quantification of the financial effects of the material misstatement that relates to specific amounts in the financial statements. Auditor should state in the basis for modification when quantification of the financial effects is impracticable.

3.3.3 Narrative disclosures and non-disclosure of information

If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for modification paragraph an explanation of how the disclosures are misstated.

If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

(a) discuss the non-disclosure with those charged with governance
(b) state in the basis for modification paragraph
(c) unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information

If there is any inability to collect sufficient and appropriate audit evidence, the auditor shall state this fact in the basis for modification for the reasons for any other matters of which the auditor is aware.

3.3.4 Opinion paragraph

(a) Heading

The auditor shall use the heading 'Qualified Opinion', 'Adverse Opinion', or 'Disclaimer of Opinion', as appropriate, for the opinion paragraph for modification of opinion.

(b) Except for

For material misstatement in the financial statements, the auditor shall state in the opinion paragraph that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph:

(i) The financial statements present fairly, in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework.

(ii) The financial statements have been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

(c) Limitation on scope

The auditor shall include in the basis for modification paragraph the reasons for that inability to obtain sufficient appropriate audit evidence.
(d) **Adverse opinion**

The auditor shall state in the opinion paragraph that, in the auditor's opinion, because of the **significance** of the matter(s) described in the Basis for Adverse Opinion paragraph:

(i) The financial statements **do not present fairly** (or give a true and fair view) in accordance with the applicable financial reporting framework when reporting in accordance with a fair presentation framework.

(ii) The financial statements have not been prepared, in all material respects, in accordance with the applicable financial reporting framework when reporting in accordance with a compliance framework.

HKSA 705 (Clarified) requires that when auditor considers it necessary to express an adverse opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement.

To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion on the financial statements as a whole.

The auditor shall amend the description of the auditor's responsibility for that inability to obtain sufficient appropriate audit evidence.

(e) **Disclaimer of opinion**

When the auditor **disclaims an opinion** due to an inability to obtain sufficient appropriate audit evidence, the auditor shall state in the opinion paragraph that:

(i) Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor **has not been able to obtain sufficient appropriate audit evidence** to provide a basis for an audit opinion; and, accordingly

(ii) The auditor **does not express** an opinion on the financial statements.

HKSA 705 (Clarified) requires that when the auditor considers it necessary to disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement as this would create contradiction.

The auditor shall **amend** the introductory paragraph of the auditor's report to state that the auditor was engaged to audit the financial statements. The auditor shall also amend the description of the auditor's responsibility and the description of the scope of the audit to state only the following: 'Our responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with Hong Kong Standards on Auditing. Because of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.'

**Self-test question 1**

Future Generation Mobile (Future Generation) is a Hong Kong listed entity which has been engaged in the mobile phone industry for many years. It has borrowed a large sum to pay for a 5G license to operate a mobile network with the latest video technology. However, having launched for nine months, it has proved to be unpopular. The entity's share price has significantly dropped since the launch and there have been several changes of the CEO and CFO during that period. There has been extensive media press over the last three months about Future Generation's ability to continue as a going concern. Rumours have been circulating as to whether the entity would be taken over by its competitors. However, no further bidders have been discovered for a takeover action.
The entity's net assets have decreased in great amount with financial commentators considering doubt on the future growth of the entity. However, some commentators are still confident that the existing business can survive although it has been necessary for the entity to restructure its finances. Detailed disclosures of all of these matters have always been made in the financial statements. The going concern status of the entity has never been mentioned in any previous auditor's reports. The deterioration in circumstances in the current year is no worse than it has been in previous years.

**Required**

Describe the audit report that you consider is likely to be issued in the case of Future Generation based on the above facts and the reasons for the suggested report.

*(The answers are at the end of the chapter)*

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**Self-test question 2**

During the audit of XZY Pty Limited (XZY) you noted the following independent items:

(a) XZY has made a provision of HK$250,000 for doubtful debts. Based on your audit work, you are of the opinion that a provision of HK$450,000 should be made instead.

(b) Total cash balance at the reporting date was HK$740,000, kept in several bank accounts of XZY. Some of these bank accounts are in a foreign country. The amount of cash kept in the accounts maintained in the foreign country was HK$528,750. You have been unable to obtain bank audit confirmations or any other third party confirmations with respect to the foreign bank accounts.

   The entity has been unable to supply you with bank statements or other supporting documentation in relation to these bank accounts.

   All cash balances are classified as current assets in the entity's financial statements.

(c) XZY is highly computerised and would be unable to transact business in the event of a prolonged computer failure. Your audit reveals no back-up and recovery procedures, no contingency plans, and no business interruption insurance in the case of such an event.

You are unsure how to proceed and have just gone to see the audit manager for advice.

**Required**

The audit manager is happy to assist you, but first he wants to hear, for each of the items independently:

- What you would do prior to issuing the auditor’s report
- The type of report you would issue and why.

*(The answer is at the end of the chapter)*

---

4 **Emphasis of matter and other matter paragraphs**

**Topic highlights**

An emphasis of matter paragraph is used by the auditor to highlight an issue affecting the financial statements which the readers should know about but which does not give rise to a modified opinion.
**Key terms**

In certain circumstances, an auditor's report may be modified by adding an **emphasis of matter** to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph **does not affect** the auditor's opinion. The auditor may also modify the auditor's report by using an emphasis of matter paragraph to report matters other than those affecting the financial statements as such importance that they are fundamental to users’ understanding.

**Other matter paragraph** – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users’ understanding of the audit, the auditor's responsibilities or the auditor's report.

### 4.1 Emphasis of matter

Under HKSA 706 (Clarified) the paragraph is normally included after the opinion paragraph and would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

The heading of ‘Emphasis of Matter’, or other appropriate heading should be presented. A clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements should be stated in the paragraph.

To summarise, the auditor shall:

- (a) include the emphasis of matter immediately after the Opinion paragraph in the auditor's report
- (b) use the heading ‘Emphasis of Matter’, or other appropriate heading
- (c) include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements
- (d) indicate that the auditor's opinion is not modified in respect of the matter emphasised

There are various **examples** of circumstances where the auditor may consider it necessary to include an emphasis of matter paragraph:

- (a) An **uncertainty** relating to the **future outcome** of exceptional litigation or regulatory action
- (b) **Early application** (where permitted) of a new accounting standard (for example, a new Hong Kong Financial Reporting Standard) that has a pervasive effect on the financial statements in advance of its effective date
- (c) A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position

**Inherent uncertainty**

In certain circumstances, an auditor's report may be modified by adding a paragraph to highlight a material matter regarding a **going concern problem** or if there is a **significant uncertainty**, the resolution of which is dependent upon future events and which may affect the financial statements and not under the direct control of the entity.

The circumstances include those listed below:

- (a) **Additional disclosures** with which the auditor concurs

  The disclosures in accordance with accounting standards could be potentially misleading but these disclosures are necessary and it is in line with the objectives of a general purpose financial report.
(b) **Inherent uncertainty** (including going concern) that is adequately disclosed

Outcome of item or disclosure contingent upon future events that is not susceptible to reasonable estimates prior to the issue of the auditor's report, for example, going concern, lawsuit.

Inherent uncertainty with adequate disclosure – **Unqualified opinion**

Inherent uncertainty with **inadequate disclosure** – This constitutes a disagreement with management and therefore an ‘except for’ or adverse opinion is to be given (see below).

HKSA 706 (Clarified) requires that an emphasis of matter paragraph shall refer only to information presented or disclosed in the financial statements. For some of the HKSAs:

<table>
<thead>
<tr>
<th>HKSA 210 (Clarified)</th>
<th>Agreeing the Terms of Audit Engagements</th>
</tr>
</thead>
<tbody>
<tr>
<td>HKSA 560 (Clarified)</td>
<td>Subsequent Events</td>
</tr>
<tr>
<td>HKSA 570 (Clarified)</td>
<td>Going Concern</td>
</tr>
</tbody>
</table>

**Sample wording:**

**Example 1**

**Emphasis of matter**

We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the Company by DEF Company. Our opinion is not qualified in respect of this matter.

**Example 2**

**Emphasis of matter**

Without qualifying our opinion, we draw attention to Note X in the financial statements which indicates that the Company incurred a net loss of ZZZ during the year ended 31 December 2010 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with the matters as set forth in Note X, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.
4.2 Other matter paragraph

When an other matter paragraph is included to draw users' attention to a matter relevant to their understanding of the audit of the financial statements, the paragraph is included immediately after the opinion paragraph and any emphasis of matter paragraph.

Circumstances in which an other matter paragraph may be necessary:

(a) When the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive, the auditor may consider including an other matter paragraph in the auditor's report to explain the fact.

(b) The auditor can elaborate matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon under law, regulation or generally accepted practice in a jurisdiction.

(c) An entity may engage the auditor to report on both sets of financial statements under two general purpose frameworks (ie Hong Kong Financial Reporting Standards and the International Financial Reporting Standards).

The auditor may include an other matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

(d) When the auditor's report is intended for specific users, the auditor may consider it necessary to include an other matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

Self-test question 3

You are the audit manager of Jackson CPA firm. You are responsible for the audits of the financial statements of a new entity, Kristy Jewellery (Kristy), for the year ended 31 December 20Y0.

The auditors of Kristy's financial statements for the year ended 31 December 20X9 have modified their report by adding an explanatory paragraph on the fundamental uncertainty in respect of Kristy's ability to continue as a going concern. Your assistant has suggested to you that the modification will not affect the audit work for the current year since the modification did not affect the reliability of individual items of information reported in the audited financial statements for the year ended 31 December 20X9.

Required

Do you agree with your audit assistant's view about the modification in the auditors' report for Kristy's financial statements for the year ended 31 December 20Y0 with regard to Kristy's going concern? Explain your views.

(The answer is at the end of the chapter)

4.3 Summary

We summarise here the relevant HKSA s that contain requirements relating to emphasis of matter and other matter paragraphs.
List of HKSAs containing requirements for emphasis of matter paragraphs

| HKSA 210 (Clarified) Agreeing the Terms of Audit Engagements |
|HKSA 560 (Clarified) Subsequent Events |
|HKSA 570 (Clarified) Going Concern |
|HKSA 800 (Clarified) Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks |

List of HKSAs containing requirements for other matter paragraphs

| HKSA 560 (Clarified) Subsequent Events |
|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 |

5 Special considerations – audit of financial statements prepared in accordance with special purpose frameworks

Topic highlights

HKSA 800 (Clarified) deals with special considerations: the audit of financial statements prepared in accordance with special purpose frameworks.

HKSA 800 (Clarified) Special Considerations – Audit of Financial Statements Prepared in Accordance with Special Purpose Framework deals with special considerations in the application of those HKSAs to an audit of financial statements prepared in accordance with a special purpose framework. The standard is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Key terms

**Special purpose financial statements** – Financial statements prepared in accordance with a special purpose framework other than a general purpose framework.

**Special purpose framework** – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

Examples of special purpose frameworks:

(a) A tax basis of accounting for a set of financial statements that accompany an entity’s tax return
(b) The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors
(c) The financial reporting provisions established by a regulator to meet the requirements of that regulator
(d) The financial reporting provisions of a contract, such as a bond indenture, a loan agreement, or a project grant

5.1 Factors when accepting the engagement

In an audit of special purpose financial statements, the auditor shall obtain an understanding of:
(a) the purpose for which the financial statements are prepared
(b) the intended users
(c) the steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances

5.2 Considerations when planning and performing the audit

In planning and performing an audit of special purpose financial statements, the auditor shall determine whether application of the HKSA requires special consideration in the circumstances of the engagement.

In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements.

5.3 Forming an opinion

When forming and reporting on special purpose financial statements, the auditor shall apply the requirements in HKSA 700 (Clarified).

In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information.

The following is an extract to show the financial statements have been prepared by management of the entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework) to comply with the provisions of that contract.

(Appropriate Addressee)

We have audited the financial statements of ABC Limited.....

The financial statements have been prepared by management of the Company based on the financial reporting provisions of Section 2 of the contract dated 1 January 2010 between the Company and DEF Company ('the contract').

Management's Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the financial reporting provisions of Section Z of the contract, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Basis of Accounting and Restriction on Distribution and Use

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company to comply with the financial reporting provisions of the contracts referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Company and DEF Company and should not be distributed to or used by parties other than the Company or DEF Company.

The following is an alternative illustration to demonstrate that the financial statements have been prepared by management of a partnership in accordance with the tax basis of accounting in Jurisdiction X (that is, a special purpose framework) to assist the partners in preparing their
individual income tax returns. Management does not have a choice of financial reporting frameworks.

(Appropriate Addressee)
We have audited the financial statements of ABC Partnership ('the Partnership')......
The financial statements have been prepared by management using the tax basis of accounting in Jurisdiction X.

Management’s Responsibility for the Financial Statements
Management is responsible for the preparation of these financial statements in accordance with the tax basis of accounting in Jurisdiction X, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Opinion
In our opinion, the financial statements of the Partnership for the year ended 31 December 2010 are prepared, in all material respects, in accordance with (describe the applicable income tax law) of Jurisdiction X.

Basis of Accounting and Restriction on Distribution and Use
Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the partners of the Partnership in preparing their individual income tax returns. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Partnership and its partners and should not be distributed to parties other than the Partnership or its partners.

6 Special considerations – audits of single financial statements and specific elements, accounts or items

Topic highlights
HKSA 805 (Clarified) deals with special considerations – audits of single financial statements and specific elements, accounts or items of a financial statement.

HKSA 805 (Clarified) Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement is a new auditing standard that deals with special considerations in the application of those HKSA to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework where HKSA 800 (Clarified) would also apply.

Key terms
‘Element of financial statement’ or ‘element’ means an ‘element, account or item of a financial statement’.

A single financial statement or a specific element of a financial statement includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.
This HKSA does not apply to the report of a component auditor when a group audit is involved. This HKSA is effective for audits of single financial statements or of specific elements, accounts or items for periods beginning on or after 15 December 2009.

In the case of an audit of a single financial statement or of a specific element of a financial statement, this requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements.

6.1 Factors when accepting the engagement

6.1.1 Application of HKSAs

If the auditor is not also engaged to audit the entity's complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with all HKSAs is practicable.

6.1.2 Acceptability of the financial reporting framework

In the case of an audit of a single financial statement or of a specific element of a financial statement, this shall include consideration or whether application of the financial reporting framework (HKSA 210 (Clarified)) will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element. It will also require consideration of the effect of material transactions and events on the information conveyed in the financial statement or the element.

6.1.3 Form of opinion

In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances.

6.2 Considerations when planning and performing the audit

In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all HKSAs relevant to the audit as necessary in the circumstances of the engagement.

6.3 Forming an opinion

HKSA 700 (Clarified) shall be applied when forming an opinion and reporting on a single financial statement or on a specific element of a financial statement. If the auditor is also auditing the entity's complete set of financial statements, he shall express a separate opinion for each engagement. An audited single financial statement or an audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements.

6.3.1 Emphasis of matter paragraph

If the opinion in the auditor's report on an entity's complete set of financial statements is modified, or that report includes an emphasis of matter paragraph or an other matter paragraph, the auditor shall determine the effect that this may have on the auditor's report on a single financial statement or on a specific element of those financial statements.

The auditor shall modify the opinion on the single financial statement or on the specific element of a financial statement, or include an emphasis of matter paragraph or an other matter paragraph in the auditor's report where appropriate.
6.3.2 Adverse opinion or disclaimer of opinion

If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity’s complete set of financial statements as a whole, HKSA 705 (Clarified) does not permit the auditor to include in the same auditor’s report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element that forms part of those financial statements.

This is the case even if the auditor’s report on the single financial statement is not published together with the auditor’s report containing the adverse opinion or disclaimer of opinion.
The auditor is required to produce an **auditor's report** at the end of the audit which sets out his **opinion** on the truth and fairness of the financial statements. The report contains a number of **consistent elements** so that users know the audit has been conducted according to **recognised standards**.

**Modified audit reports** arise relating to matters that do not affect the auditor's opinion and matters that do affect the auditor's opinion.

An **emphasis of matter paragraph** is used by the auditor to highlight an issue affecting the financial statements which the readers should know about but which does not give rise to a modified opinion.

HKSA 800 (Clarified) deals with special considerations: the audit of financial statements prepared in accordance with a Special Purpose Framework.

A special purpose framework is a financial reporting framework designed to meet the needs of specific users.

HKSA 805 (Clarified) deals with special considerations – audits of single financial statements and specific elements, accounts or items of a financial statement.
Answers to self-test questions

Answer 1

Report issued to Future Generation

The situation has not deteriorated significantly in the current year and it will be difficult for auditors to justify any change in their opinion from previous years. Therefore, the audit opinion issued on Future Generation in the current year is not likely to make reference to the going concern status of the entity, as in previous years.

According to the facts, there are definitely some going concern indicators, however the entity may still be a going concern and the fact that the entity has been approached by takeover bidders does not necessarily mean that there is a going concern problem.

If the auditors of Future Generation were to report on a going concern problem, reporting might of itself create a going concern problem causing a further decrease in share price. In addition, the loan providers may demand repayment of loans immediately.

Answer 2

(a) The following factors need to be considered:

(i) Whether your estimate of the provision of impairment loss of HK$450,000 is a more appropriate estimate than the management's estimate

(ii) Whether the amount of under-provision of HK$200,000 is material

(iii) The entity's opinion of your assessment of the provision of HK$450,000. There may be circumstances that would change your judgment, that is, ensure that you and your entity are aware of the same information in making the judgment on the appropriate amount of provision

(iv) Review prior year financial statements for any prior year qualification; and explain to the entity any qualification of the auditor's report would entail

Assume that, after the above considerations, you are still of the opinion that there is an underprovision of HK$200,000 in the provision for doubtful debts, an 'except for disagreement' qualification should be issued. Although the disagreement may be material, it would probably be unlikely that the financial statements are seriously misleading and therefore an adverse opinion should be unlikely.

(b) The following factors need to be considered:

(i) Are there are alternative procedures to obtain evidence regarding the assertions of the existence and rights and obligations of the cash balance?

(ii) Whether the amount of HK$528,750 is material

(iii) Why bank audit confirmations, third party confirmations or bank statements, or other supporting in relation to the bank balance are not available

(iv) Whether there was a prior year qualification (also review the account to see if there has been any movement in the balance during the year)

Assume that, after the above considerations, the assertions of the existence and the rights and obligations of the HK$528,750 bank account balances cannot be verified, an 'except for disagreement' qualification should be issued if the matter is material. Since XZY cannot present any documentary support of the bank balances, it is not
unreasonable to conclude that XZY cannot enforce its claims over the 'bank balances'. Therefore, the 'bank balances' should not be recognised as an asset in the financial statements. If the effect is so material or pervasive that the financial statements are seriously misleading, an adverse opinion should be issued.

(c) The following factors need to be considered:

(i) What the effects of a prolonged computer failure will be

(ii) Whether a prolonged computer failure and lost of computer data will have material effect on the going concern of the entity

(iii) If it is reasonable to conclude that a prolonged computer failure and lost of computer data will cause a significant level of concern about the validity of the going concern basis, for example, the entity will no longer be able to collect debts from customers. Due to loss of data or significant claims for losses by outside parties due to failure of the computer operation, the matter should be dealt with in accordance with HKSA 570 (Clarified) Going Concern.

**Answer 3**

**Possible existence of going concern indicators in the current year**

Although modification of the auditors' opinion was not based on the reliability of a single item of financial information reported in Kristy's financial statements for the previous year, the modification highlighted the existence of a fundamental uncertainty relating to the event or condition that may cast significant doubt on Kristy's ability to continue as a going concern.

Since this fundamental uncertainty may continue to exist in the current year, we need to assess how such uncertainty may affect our audit work and reporting.

In planning our audit of Kristy's financial statements for the year ended 31 December 20Y0, we should assess whether any of the events or conditions that may cast significant doubt on the going concern of Kristy ('going concern indicators') mentioned by Kristy's previous auditors continue to exist.

During the course of our audit, we should also be alert to other going concern indicators not mentioned by Kristy's previous auditors.

**Audit work if going concern indicators exist**

If such going concern indicators continued or new indicators are identified, we should

(a) Consider whether they affect our assessments of the components of audit risk

(b) Review management plan of Kristy for future actions based on its going concern assessment

(c) Gather sufficient appropriate audit evidence to confirm or dispel the notion that a fundamental uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors

(d) Seek written representations from Kristy's management regarding its plans for future action

**Other matters requiring emphasis of matter paragraph**

The auditor may also modify the report by using an emphasis of matter paragraph for matters which do not affect the financial statements such as:

(a) **Other information in documents containing audited financial statements**

The auditor should read other information issued at the same time as the financial statements, and if they become aware of any material inconsistencies, they should seek to resolve them.

Auditors should consider whether information contained is consistent with financial statements and if not should state that fact in auditor's report.
If there is an inconsistency, the document which is wrong needs to be changed.
If the uncertainties are so significant to the financial statements, a **disclaimer of opinion** may be required.

(b) **Actual or possible material misstatements** – not affecting current period's figures
(c) **Reference to note** for explaining revised financial statements
(d) **Emphasise the findings of an expert**

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MODIFIED OPINION

MATTERS THAT DO NOT AFFECT THE AUDITOR’S OPINION
  EMPHASIS OF MATTER or OTHER MATTER PARAGRAPH
    Going concern (fundamental uncertainty)
    Properly account for and properly disclose
    Actual or possible material misstatements

MATTERS THAT DO AFFECT THE AUDITOR’S OPINION
  'EXCEPT FOR' OPINION
  ADVERSE OPINION
  DISCLAIMER OPINION
    Including other information in audited financial statements
    Reference to note
    Emphasise the findings of an expert
```
QQ Laundry Ltd

QQ Laundry Ltd has ten shops in Hong Kong. One of the shops has been making a loss because of its poor location. The tangible assets of the loss-making shop mainly comprise commercial washing machines and dryers and are stated at $500,000 (after a write-down for impairment loss of $100,000) in the draft financial statements. The auditors consider that the reported value of the assets ($500,000) is material to the financial statements of QQ Laundry Ltd.

There is a brand new residential estate close to the loss-making shop, and residents have recently started moving in. Accordingly, business has improved slightly, and the management of QQ Laundry Ltd expect to see the shop turning profitable during the new financial year. According to the management, the value of the assets to the business would be greater than $500,000 when the shop is profitable.

All relevant audit evidence suggests that the shop is to close if its business does not improve significantly. If the shop closes, its assets would be worth nothing because the cost of moving them to other shops would exceed their net realisable value.

Required

State whether or not the audit report should be qualified and explain the most appropriate type of qualification (if applicable) in each of the two following situations:

(a) The auditors agree with the management's assessment of the uncertainty over the tangible assets at the loss-making shop; and (7 marks)

(b) The auditors disagree with the management's assessment and are convinced that losses will continue, leading to closure of the loss-making shop and requiring the complete write-off of the assets. (7 marks)

(Total = 14 marks)

HKICPA February 2006
Part E
Other audit matters

This Part discusses the management aspect of an assurance process, e.g. a group audit situation, and other assurance engagements. It will also embrace any issues not covered in the basic context.
chapter 18
Group audits

Topic list
1. Audit of groups
2. The group engagement partner
3. Joint audits

Learning focus
HKSA 600 (Clarified) Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) is effective for audits of financial statements for periods beginning on or after 15 December 2009. This HKSA deals with special considerations that apply to group audits, especially when those involve component auditors.
Learning outcomes

In this chapter you will cover the following learning outcomes:

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<th>Competency level</th>
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<td>2.09</td>
<td>Audit procedures</td>
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<tr>
<td>2.09.11</td>
<td>Recognise and explain the issues relating to the audit of a group of companies</td>
</tr>
<tr>
<td>2.12</td>
<td>Completion procedures</td>
</tr>
<tr>
<td>2.12.01</td>
<td>Explain the purpose of and the procedures to be used in:</td>
</tr>
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<td>2.12.01.04</td>
<td>Review of report by other auditors to principal auditors of a group of companies</td>
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1 Audit of groups

Topic highlights
Auditing a group of companies adds another level of complexity to an audit assignment, as the auditor has to consider issues that relate to the individual companies and also the group as a whole. Key procedures such as the assessment of audit risk and the assignment of materiality have to be approached in a different way.

The applicable regulatory and financial reporting framework for a group in Hong Kong is the Companies Ordinance and HKFRSs.

If a holding company and its subsidiary are incorporated in Hong Kong, Section 133(1)(a) of the Companies Ordinance imposes a duty on the subsidiary and its auditors to give to the auditors of the holding company such information and explanation as those auditors may reasonably require for the purposes of their duties as auditors of the holding company.

Where a holding company is incorporated in Hong Kong, but its subsidiary is not, Section 133(1)(b) of the Companies Ordinance imposes a duty on the holding company, if required by its auditors to do so, to take all such steps as are reasonably open to it to obtain from the subsidiary such information and explanation as the group engagement team may reasonably require for the purpose of their duty as the group engagement team.

Key terms
For the purpose of HKSA 600 (Clarified), the following terms have the following meanings:

Group engagement team – Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group engagement partner – The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Component auditor – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Significant component – A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

1.1 Significant components
It is important to consider whether the component is a significant component or not. The following factors should be considered for determining a significant component:

(a) Individually significant component:
The risks of material misstatement of the group financial statements would increase when the individual financial significance of a component increases. The group engagement team, using professional judgment may identify a benchmark (such as group assets, turnover or profit etc) and determine a percentage to be applied to identify which are significant components.
(b) Component likely to include significant risks of material misstatement of the group financial statements

The group engagement team may identify a component that is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances.

1.2 Group-wide controls

Key term

Group-wide controls are controls designed, implemented and maintained by group management over group financial reporting.

Some of the examples of group-wide controls follow:

(a) Regular meetings between group and component management
(b) Monitoring controls over components’ operations and financial results
(c) Group management’s risk assessment process – process identifying, analysing and managing business risks for the group
(d) Intra-group transactions – monitoring, controlling, reconciling and eliminating intra-group transactions and unrealised profits
(e) Components' financial information – monitoring process of the timeliness and assess the accuracy and completeness of these financial information
(f) IT controls – a central IT system controlling all general IT controls for all or part of the group and control activities within an IT system applying for all or some components
(g) Monitoring controls – internal audit and self assessment programmes applied to the group
(h) Group financial reporting procedures manual – consistent policies and procedures applied to the group
(i) Group-wide programmes – Codes of conduct and fraud prevention programmes
(j) Assigning authority and responsibility of component management

2 The group engagement partner

2.1 Objectives

The group engagement partner has three main objectives:

(a) To determine whether it is appropriate to act as the auditor of the group financial statements
(b) To communicate effectively with the component auditors relating to the scope and timing of their work on financial information related to components and their findings
(c) To obtain sufficient appropriate evidence regarding the financial information of the components to enable an opinion to be formed on the group financial statements
2.2 The group engagement partner's responsibilities

**Topic highlights**

The group engagement partner is responsible for the **direction, supervision and performance** of the group audit engagement in compliance with HKSA and the Hong Kong Companies Ordinance. S 141(4) and S 141(6).

Under HKSA 600 (Clarified), the group engagement partner has **sole responsibility** to express an opinion on the group financial statements even for components that the group engagement partner has not audited. As a result, the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation.

2.3 Quality control requirement for the group engagement partner

The group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the **appropriate competence and capabilities** (HKSA 220 (Clarified)).

2.4 The group engagement partner's rights

**Topic highlights**

The group engagement partner has the right to require from component auditors the information and explanations they require, and to require the group management to take all reasonable steps to obtain the necessary information and explanations from subsidiaries.

The group engagement partner has **all the statutory rights and powers** in respect of their audit of the holding entity of access at all times to the holding entity's books, financial statements and vouchers.

Even where their responsibilities in this regard are not set down by statute, the component auditors should appreciate that the subsidiaries' financial statements will ultimately form a part of the group financial statements. In principle, the component auditors should therefore be prepared to **co-operate** with the group engagement team.

2.5 Acceptance and continuance

**Topic highlights**

For significant components the group engagement partner should consider whether their **participation** will be sufficient to obtain sufficient appropriate evidence and should determine how the work of the component auditors will affect the group audit.

When considering whether to accept appointment or continue as auditors, the group engagement partner, should determine whether **sufficient appropriate audit evidence** can reasonably be expected to be obtained in relation to the **consolidation process** and the financial information of the components on which to base the group audit opinion'. Where possible, a firm will tender for the audit of all significant components within a group. Where this is not possible, which may be for a wide variety of reasons, the group engagement team must identify the materiality of the portion of the financial statements.
the financial statements he is responsible for to build an understanding of the group, its components, and their environments sufficient to identify which are significant components.

To obtain this understanding he will refer to the following sources:

In the case of a new engagement:
- Information provided by group management
- Communication with group management
- Where applicable, communication with the previous group engagement team or component auditors

If he is satisfied that group management will provide sufficient co-operation and access to carry out the audit effectively he may accept the engagement.

The engagement partner will also consider the following:
- The group structure – the group, its components and their environment
- Their knowledge of the component's business activities including the industry and regulatory, economic and political environments in which they operate
- The materiality of that part of the group that they do not audit and the risk of material misstatement in their financial statements before consolidation through fraud or error
- How the relationship with the component auditors can be managed effectively
- Whether the firm has the capability to perform more work
- The use of service organisations
- A description of group-wide controls
- The complexity of the consolidation process
- Instructions issued by group management to components and how centralised its controls are
- Whether component auditors outside of the group engagement partner's firm will perform work on the financial information of any of the subsidiaries
- Whether the group engagement auditors will have unrestricted access

For continuing engagements, the group engagement partner's ability to obtain sufficient appropriate audit evidence may be affected by significant changes, such as changes in organisational structure, the nature of business activities or concerns regarding either the integrity or competence of group's or subsidiaries' management.

Where components within the group are likely to be significant components, the group engagement partner evaluates the extent to which the group engagement team will be able to be involved in the work of those component auditors.

The group engagement partner must either refuse to accept, or resign from the engagement if he concludes that it will not be possible to obtain sufficient appropriate audit evidence due to restrictions imposed by group management.

2.6 Planning and risk assessment

The most significant aspect of the planning and risk assessment process in this situation is the fact that all elements of the group financial statements are not audited directly by the group engagement team. Therefore, there is the risk that a component auditor may fail to detect a risk in the component's financial statements which becomes consolidated in the group financial statements. According to HKSA 600 (Clarified) it is not sufficient for the engagement team to rely only on the conclusions of the component auditor but must first evaluate the reliability of the
component auditor and the work performed (see Section 2.6.2 below). The results of their assessment will then inform what further procedures are necessary.

2.6.1 Overall strategy and audit plan
Under HKSA 600 (Clarified), the group engagement team shall formulate an overall group audit strategy, develop a group audit plan and conduct ongoing reviews to monitor progress against audit objectives.

2.6.2 Understanding the group, the component auditor and their environment
HKSA 600 (Clarified) stipulates that the group engagement team is to obtain an understanding of the component auditor. It goes on to describe what this means in practice:

(a) Assessment of whether the component auditor is independent and understands and will comply with the ethical requirements that are relevant to the group audit
(b) Whether the component auditor's professional and technical competence is sufficient to deal with the audit of the appropriate complexity
(c) Whether the group engagement team will be involved in the work of component auditors to the extent that it is necessary to obtain sufficient appropriate audit evidence
(d) Whether the component auditor operates in a regulatory environment that actively oversees auditors

There are various ways to obtain this information. For example, in the first year, the group engagement partner and his team may visit the component auditors for face-to-face discussions. Alternatively, the component auditor may be requested to confirm these matters in writing or to complete a pre-set questionnaire. The group engagement partner auditors may review the working papers of component auditors. Confirmations from professional bodies may also be sought and the reputation of the firm will be taken into account.

2.6.3 Component materiality
The group engagement team is responsible for setting the materiality level for the group financial statements as a whole. Materiality levels should also be set for components which are individually significant. These should be set at a lower level than the materiality level of the group as a whole. The group engagement team shall evaluate the appropriateness of performance materiality determined at the component level and determine the threshold for statements that cannot be regarded as clearly trivial to the group financial statements.

2.6.4 Work of the group engagement team
Work on individual significant component
HKSA 600 (Clarified) requires that the engagement team shall perform an audit of the financial information of the significant component using component materiality and the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements.

The group engagement team shall also determine the nature, timing and extent of its involvement in the work of the component auditors. Based on these factors the group auditors may perform the following procedures:

(a) Meeting with the component management or the component auditors to obtain an understanding of the component and its environment
(b) Reviewing the component auditor's overall audit strategy and audit plan
(c) Performing risk assessment procedures to identify and assess risks of material misstatement at the component level. These may be performed with the component auditor or by the group engagement team
(d) Discussion with the component auditor or component management regarding the component's business activities that are significant to the group and the audit procedures to be carried out

(e) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error, by considering fraud risk factors

(f) Reviewing the component auditor's documentation of identified significant risks of material misstatements. This may be in the form of a memorandum including the conclusions drawn by the component auditors

(g) Consider significant findings of the component auditors

(h) Give appropriate advice to component auditors

(i) Obtain written representations from the component auditors

**Work on component that is likely to include significant risks of material misstatement of the group financial statements**

HKSA 600 (Clarified) requires:

(a) the group engagement team, or a component auditor on its behalf, shall perform an audit or review of the financial information of the component using component materiality;

(b) audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements; and

(c) specified audit procedures should be carried out.

**Work on components other than significant components**

HKSA 600 (Clarified) requires:

(a) the group engagement team shall perform analytical procedures at group levels; and

(b) the group engagement shall perform, or request a component auditor to perform, specific audit procedures.

**Work on group-wide controls**

HKSA 600 (Clarified) requires that the group engagement team shall test, or request a component auditor to test, the operating effectiveness of those controls (tests of controls) when:

(a) the nature, extent and timing of the work to be performed on the consolidation process or the financial information of components are based on the expectation that group-wide controls are operating effectively

(b) if substantive alone cannot provide sufficient appropriate audit evidence at the assertion level

**Further work on consolidation process**

HKSA 600 (Clarified) requires that the group engagement team shall design and perform further audit procedures on the consolidation process to response to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. The procedures involve evaluation of all the following:

(a) Whether all components have been included in the group financial statements

(b) The appropriateness, completeness and accuracy of consolidation adjustments and classification

(c) Whether any fraud risk factors or indicators of possible management bias exists in making accounting estimates
(d) Whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements when the financial information has not been prepared with the group accounting policies

(e) Whether appropriate adjustments have been made when financial statements prepared by the component auditor have different financial reporting period-end

**Work on subsequent events**

The group engagement team (or the component auditors) shall perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor’s report on the group financial statements, as that may require adjustment to or disclosure in the group financial statements.

2.7 **Evaluating the work of the component auditor**

For all entities in the group, the group engagement partner is required to perform a review of the work done by the component auditor. This is normally achieved by reviewing a report or questionnaire completed by the component auditor which highlights the key issues which have been identified during the course of the audit. The effect of any uncorrected misstatements and any instances where there has been an inability to obtain sufficient appropriate audit evidence should also be evaluated. On the basis of this review, the group engagement partner then needs to determine whether any additional procedures are necessary.

These may include:

(a) evaluating the component auditor’s communication by discussing significant matters arising from that evaluation with the component auditor, management or group management;

(b) designing and performing further audit procedures. (These may be designed and performed with the component auditors, or by the group engagement partner);

(c) participating in the closing and other key meetings between the component auditors and component management; and

(d) reviewing other relevant parts of the component auditors’ documentation.

If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed and whether they are to be performed by the component auditor or by the group engagement team.

2.8 **Component auditor’s responsibilities**

A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of a component.

The component auditor should always co-operate with the group engagement partner.

If the component is a Hong Kong subsidiary, there is a statutory obligation on component auditors to give the group engagement team information and explanations. It is necessary to consider whether its incorporation is in Hong Kong, and whether the reporting entity is subject to the Hong Kong Companies Ordinance and can take all reasonable steps to obtain from its subsidiary any information and explanations.

If the component auditors have no statutory obligation but the group engagement team has stated the intention to use the work of the component auditors, they may need consent from the entity that they audit to communicate with the group engagement team. If the permission is refused, the component auditor should inform the group engagement team of the refusal.

The component auditor should inform the group engagement team of any work that cannot be carried out or any significant relevant matters. The component auditor has sole responsibility for the audit opinion on the financial statements of the component they audit.
The component auditor should not rely on the group engagement team to inform them of material information. For any communication to the group engagement team, the component auditors should consider confidentiality.

2.9 Reporting

**Topic highlights**
The group engagement partner takes sole responsibility for the group audit opinion.

The following are some of the conditions that a group engagement partner would face when considering issuing his audit report on the group financial statements:

**CONDITION (1) – If satisfied with the work performed by component auditors**

If the group engagement team is satisfied that the work of the component auditors is adequate for the purposes of the audit, **no reference** to the component auditors should be made in the group engagement team's report.

The group engagement partner has **sole responsibility for their audit opinion**. If they refer to component auditors, it may be misinterpreted as a qualification of their opinion or as a division of responsibility.

**CONDITION (2) – If the group engagement partner concludes that the work of the component auditor cannot be used** and it is not possible to perform additional procedures regarding the component that the component auditor's audit

The group engagement partner should consider the **implications for the group audit report** and may need to qualify if material, or give a disclaimer of opinion as there is a **limitation in the scope of work**.

**CONDITION (3) – Where component auditors' report contains a qualification or explanatory paragraph relating to fundamental uncertainty**

The group engagement partner should consider whether the qualification or uncertainty is **material in the context of the group**. It can be material to the component and not material in the group's perspective and qualification may not be required in respect of the group.

2.10 Communication

The group engagement team shall communicate their requirements to the component auditors on a **timely basis**. This communication shall set out the work to be performed, the use to be made of that work and the form of the component auditor's communication with the group engagement team.

These communications include the following:

(a) A request that the component auditor confirms their co-operation with the group engagement auditors

(b) The ethical requirements that are relevant to the group audit and, in particular, independence requirements

(c) In the case of an audit or review of the financial information of the component, consider the component materiality

(d) Identified significant risks of material misstatement of the group financial statements, due to fraud or error that are relevant to the work of the component auditor. The group engagement partner requests the component auditor to communicate any other identified significant risks of material misstatement and the component auditor's responses to such risks
(e) A list of related parties prepared by group management and any other related parties of which the group engagement team is aware. Component auditors are requested to communicate any other related parties not previously identified.

The group engagement team shall evaluate the component auditor's communication. The group engagement team shall determine if any additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

The group engagement partner should determine whether the group financial statements as a whole are misstated as part of the process of evaluation of the aggregate effect of any misstatements.

The group engagement team shall request the other auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Such communication shall include the following:

- Whether the component auditor has complied with ethical requirements, being independent and competent
- Whether the component auditor has complied with the group engagement team's requirements
- Identification of the financial information of the component on which the component auditor is reporting
- Any instances of non-compliance with laws and regulations that could give rise to a material misstatement of the group financial statements
- A list of uncorrected misstatements of the financial information of the component
- Indicators of possible management bias
- Description any identified significant deficiencies in internal control at the component level
- Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component
- Any other matters relevant to the group audit or that the component auditor for drawing attention to the group engagement team
- The component auditor's overall findings, conclusions or opinion

2.11 Communicating with group management and those charged with governance

The following matters should be communicated to group management:

(a) Deficiencies in the design or operating effectiveness of group-wide controls
(b) Deficiencies that the group engagement team has identified in internal controls at components that are judged to be significant to the group
(c) Deficiencies that component auditors have identified in internal controls at components that are judged to be significant to the group
(d) Fraud identified by the group engagement team or component auditors or information indicating that a fraud may exist. Timely reporting should be communicated to the group management
(e) Group management may need to keep certain material sensitive information confidential

2.12 Communication with those charged with governance of the group

The auditor should communicate the following matters to those charged with governance of the group:
(a) An summation of the work to be performed on the financial statements of the component
(b) A description of the extent of group engagement team's planned involvement in the work to
be performed by component auditors on significant components
(c) Any areas where the work of the component auditor gives the engagement team concern
about the quality of that auditor's work or their independence
(d) Any restrictions on the group audit, for instance, where the component's management may
have limited access to data or information
(e) Any suspicions or evidence of fraud involving group management, component management,
employees who have significant roles in group-wide controls or where fraud has caused a
material misstatement in the assertions of the group financial statements

Self-test question 1
You are the main auditor of Brandy Holdings, a Hong Kong listed entity, which has subsidiaries in
the Hong Kong and overseas, many of which are audited by other firms. All subsidiaries are
involved in the manufacture or distribution of children's toys and have accounting periods the same
as that of the holding entity.
(a) As the group engagement partner, describe the reasons why you would wish to review the
work of the component auditors of the subsidiaries not audited by you.
(b) Describe the principal audit procedures you would carry out in performing such a review.

(The answer is at the end of the chapter)

3 Joint audits

Topic highlights
In joint audits, more than one auditor is responsible for the audit opinion. In some jurisdictions they
are compulsory.

Key term
A joint audit is one 'where two or more auditors are responsible for an audit engagement and
jointly produce an audit report to the entity'.

Where joint auditors conduct the group audit, the joint engagement partners and their engagement
teams collectively constitute the group engagement partner and the group engagement team.
The relationship between joint auditors or the work that one joint auditor performs in relation to the
work of the other joint auditor falls outside the scope of HKSA 600 (Clarified). The management of
the relationship is the affair of the firms involved, and extensive discussions and research should
be taken concerning their respective experience, competence and working methods before a joint
audit is commenced.

3.1 Reasons for joint audits
Two or sometimes more firms of accountants may act as joint auditors for a number of reasons:
(a) Takeover/merger. The parent entity may insist that their auditors act jointly with those of the
new subsidiary; working jointly creates some continuity at a time of critical change
(b) Diverse location. An entity whose sites are widely separated geographically may find it
convenient to have more than one set of auditors working collaboratively
(c) **Political difficulties.** To comply with local legislation some overseas subsidiaries may need to employ local auditors who may act jointly with those engaged by the holding entity.

(d) Companies may prefer to use **local accountants**, while at the same time benefitting from the wider range of services or kudos provided by the involvement of a large national or 'Big Four' firm.

(e) In some jurisdictions, such as France, it is compulsory as it is seen to improve the quality of the audit and ensure independence.

### 3.2 Accepting a joint audit

Before a joint audit is accepted there are many practical issues that must be addressed. The reputation of the other firm will be important and a thorough understanding is needed of their **experience** and **standards**. Each firm will look at the other for the auditing techniques used, will scrutinise the other working papers and establish whether they have had experience in similar engagements to ensure that working collaboratively will not be to the detriment of either party.

Where joint auditors are engaged, the audit engagement should be explained in similar terms by each set of auditors. The auditors should agree whether joint or separate letters should be sent to the entity. If other services are provided, separate letters will be needed.

Once a joint position has been accepted the joint auditors need to work together to develop the **programme** of work and how it is to be assigned to the respective firms.

### 3.3 Drawbacks and benefits of joint audits

From the client's point of view the most likely drawback of joint audits is the additional expense and time spent by senior management in engaging two or more firms. However, if the two firms have organised the work between them effectively the impact on costs should not be that great as there should not be duplication of effort, but a wider range of resources on which to draw. Further, by appointing joint auditors the client may access a higher degree of service than a single firm could provide and its use may help to raise audit service levels in general as auditors review each other's work and the threats of self-review, intimidation and so on are therefore reduced. These positive outcomes rely on the two firms working responsibly together to produce the best outcome for the client – that is, confidence in the financial statements – rather than point scoring against each other. If the auditors compete rather than collaborate the results may be poor and costly for the entity and ultimately detrimental to both firms. Regardless of what allocations of responsibility they decide, both firms are held jointly responsible for the whole audit and both sign the final audit report. Equally, both firms are **jointly liable** in the event of litigation whether or not they carried out the disputed area of the audit.
The group engagement partner is responsible for the direction, supervision and performance of the group audit.

The group engagement partner takes sole responsibility for the group audit opinion.

The group engagement partner has the right to require from auditors of subsidiaries the information and explanations they require, and to require the group management to take all reasonable steps to obtain the necessary information and explanations from subsidiaries.

For significant components the group engagement partner should consider whether their involvement will be sufficient to obtain sufficient appropriate evidence and should determine how the work of component auditors will affect the group audit.

In joint audits, more than one auditor is responsible for the audit opinion and it is made jointly.
Answer to self-test question

Answer 1

(a) **Reasons for reviewing the work of component auditors**

It may be stated in the notes that the financial statements of certain subsidiaries have been audited by other firms, but this does not discharge the group engagement team from any of their responsibilities.

The main consideration which concerns the audit of all group financial statements is that the group engagement partner is responsible to the shareholders of that entity for the audit opinion on the whole of the group financial statements.

The group engagement partner has to report to their shareholders on the truth and fairness of the view given by the financial statements of the entity and its subsidiaries dealt with in the group financial statements.

The group engagement team should have powers to obtain such information and explanations as they reasonably require from the subsidiary companies and their auditors, or from the parent entity in the case of overseas subsidiaries, in order that they can discharge their responsibilities as the group engagement partner.

HKSA 600 (Clarified) clarifies how the group engagement partner can carry out a review of the audits of components including subsidiaries in order to satisfy themselves that, with the inclusion of figures not audited by themselves, the group financial statements give a true and fair view.

The scope, standard and independence of the work carried out by component auditors are the most important matters which need to be examined by the group engagement team before relying on financial statements audited by them. The group engagement team need to be satisfied that sufficient appropriate audit evidence has been obtained and that all material areas of the financial statements of subsidiaries have been audited satisfactorily and in a manner compatible with that of the group engagement team.

(b) The group engagement team should carry out the following work to review the component auditors’ work:

(i) Send a questionnaire to all component auditors requesting detailed information on their work, including:

   1. Details of the accounting policies of major subsidiaries (to ensure that these are compatible within the group)

   2. Any limitations placed on the scope of the auditors’ work

   3. An explanation of their general approach (in order to make an assessment of the standards of their work)

   4. The component auditors’ opinion of the subsidiaries’ overall level of internal control, and the reliability of their accounting records

   5. Any qualifications, and the reasons for them, made or likely to be made to their audit reports

(ii) Carry out a detailed review of the other auditors’ working papers on each subsidiary whose results materially affect the view given by the group financial statements. This review will enable the group engagement team to ascertain whether (inter alia):
(1) All other working papers are comprehensive and explicit

(2) The overall review of the financial statements has been adequately carried out, and adequate use of analytical procedures has been undertaken throughout the audit

(3) The financial statements agree in all respects with the accounting records and comply with all relevant legal requirements and accounting standards

(4) The audit work has been properly reviewed within the firm of auditors and any laid-down quality control procedures adhered to

(5) Any points requiring discussion with the holding entity’s management have been noted and brought to the group engagement partner’s attention (including any matters which might warrant a qualification in the audit report on the subsidiary entity’s financial statements)

(6) Adequate audit evidence has been obtained to form a basis for the audit opinion on both the subsidiaries’ financial statements and those of the group

(7) An up-to-date permanent file exists with details of the nature of the subsidiary’s business, its staff organisation, its accounting records, previous year’s financial statements and copies of important legal documents

(8) The systems examination has been properly completed, documented and reported on to management after discussion

(9) Tests of controls and substantive procedures have been properly and appropriately carried out, and audit programmes properly completed and signed

(10) Minutes of board and general meetings have been scrutinised and important matters noted

(11) The audit work has been carried out in accordance with approved auditing standards

(12) The financial statements agree in all respects with the accounting records and comply with all relevant legal and professional requirements

If the group engagement partner is not satisfied as a result of the above review, he should arrange for further audit work to be carried out either by the component auditors on their behalf, or jointly with them. The component auditors are fully responsible for their own work; any additional tests are those required for the purpose of the audit of the group financial statements.
Inter-company balances

Your firm is the auditor of Karma Industries, a limited liability entity, which has a number of subsidiaries in Hong Kong (and no overseas subsidiaries), some of which are audited by other firms of professional accountants. You have been asked to consider the work which should be carried out to ensure that inter-company transactions and balances are correctly treated in the group financial statements.

Required

(a) Describe the audit work you would perform to check that inter-company balances agree, and to state why inter-company balances should agree, and the consequences of them not agreeing.

(b) Describe the audit work you would perform to verify that inter-company profit in inventory has been correctly accounted for in the group financial statements.

(15 marks)
chapter 19
Audit-related services and other assurance engagements

Topic list
1 Audit-related services
2 Other assurance engagements
3 Pro forma financial information in investment circular reporting engagements
4 Preliminary announcement of annual results
5 Comfort letters and due diligence meetings on financial and non-financial information
6 Engagements to report on summary financial statements

Learning focus
Assurance and audit-related services are important areas for auditors in practice.
In recent years, the management of entities have been asked to provide more information to increase public accountability. As a result, auditors have been asked to report on this information, so giving rise to the need for assurance services.
In this chapter you will cover the following learning outcomes:

<table>
<thead>
<tr>
<th>Competency level</th>
<th>Other assurance engagement requirements</th>
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<tbody>
<tr>
<td>2.02</td>
<td>Identify the issues relating to other assurance and non-assurance engagements including:</td>
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<tr>
<td>2.02.01</td>
<td>Reviews</td>
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<td>2.02.01.01</td>
<td>Agreed-upon procedures</td>
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<td>2.02.01.02</td>
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<td>Comfort letters</td>
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<tr>
<td>2.02.01.06</td>
<td>Due diligence work</td>
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</table>
1 Audit-related services

Topic highlights
Audit-related services may be assurance services (reviews) or not (agreed-upon procedures and compilations).

1.1 Reviews
HKSRE 2400 – Hong Kong standard on review engagements
(Performed by practitioner who is not an auditor of the reporting entity)
HKSRE 2410 – Review of interim financial information performed by the independent auditor of the entity
(Performed by practitioner who is the auditor of the reporting entity)

Key term
Review engagements. The objective of a review engagement on the interim financial information is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor’s attention that causes the auditor to believe that the interim financial statements are not prepared, in all material respects, in accordance with an applicable financial reporting framework.

Topic highlights
A review provides a limited level of assurance that the information subject to review is free of material misstatement. The review is expressed in the form of negative assurance.

The requirement under The Rules Governing the Listing of Securities on the Hong Kong Stock Exchange (HKSE) in Hong Kong is that interim reports of listed companies should be reviewed by the audit committee. If there is not an audit committee, the auditors should perform the review. The interim report covers the first six months of its financial year and it should comprise the statement of financial position, statement of comprehensive income, the statement of cash flows, statement of movements in equity, comparative figures, accounting policies and explanatory notes.

1.1.1 HKSRE 2400 versus HKSRE 2410
A practitioner, who as the auditor of the entity, is engaged to perform a review of interim financial information performs the review in accordance with HKSRE 2410, as discussed in this Learning Pack.

Alternatively, when a practitioner who is not the auditor of an entity, undertakes an engagement to review financial statements he shall comply with HKSRE 2400. Since the practitioner does not ordinarily have the same understanding of the entity and its environment, including its internal controls as the auditors would have done, the practitioner needs to carry out different inquiries and procedures to meet the objective of the review.

1.1.2 Difference between a review and an audit
The objective of a review of interim financial statements differs significantly from an audit which is conducted in accordance with HKSAs.
A review **does not** provide a basis for **expressing an opinion** as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with an applicable financial reporting framework.

In addition, a review is **not designed to obtain reasonable assurance** that the interim financial information is free from material misstatement.

The auditor makes inquiries and performs analytical procedures in order to reduce to a moderate level of risk, the possibility of expressing an inappropriate conclusion when the interim financial information is materially misstated.

A review may bring significant matters affecting the interim financial information to the auditor's attention, but it **does not provide all of the evidence** that would otherwise be required in an audit.

### 1.1.3 General principles

**Topic highlights**

- **Assurance services** improve the quality of decision-making for users of information.
- **Assurance engagements** comprise the independent verification of data prepared by others and are often used for interim financial statements although there are many other uses. They are designed to give **reasonable assurance or limited assurance**.

When carrying out an interim review the auditor should adhere to the same **ethical principles** as when conducting the main audit of the financial statements. The same procedures also apply:

(a) The auditor should agree the **terms of the engagement** with the client. However, these will be different to those used for the audit, as the review is intended to achieve a lower level of assurance.

(b) The auditor should design the necessary **quality control procedures** for the specific engagement, depending on its scope and nature.

(c) The auditor will plan the audit, including obtaining background information about the entity to ensure the objectives of the review are achieved to the appropriate level of assurance. He will then design specific audit procedures in order to obtain the evidence he needs.

The engagement should be performed with the same **professionalism, independence of mind** and attitude of **professional scepticism** as a full audit. The HKSRE requirements reflect the requirements of an audit because a review is a very similar exercise. However, the actual tests performed may differ as inquiry and analytical procedures are used to achieve the reasonable or limited level of assurance rather than the physical inspections and third party confirmations involved in the more rigorous annual audit which seeks to achieve a higher level of assurance.

**Planning**

**In order to obtain knowledge of the business**: The inquiries and analytical procedures selected are based on the understanding of the entity, its internal controls and the auditor's judgment as to where the risks of material misstatements lie.
### Planning

The auditor shall perform the following:

- Read last year's audit and previous review files.
- Consider any significant risks that were identified in the prior year audit.
- Read the most recent and comparable interim financial information.
- Consider materiality.
- Consider the impact of any corrected or uncorrected misstatements in last year's financial statements.
- Consider any financial accounting or reporting matters of current importance.
- Consider the results of any interim audit work for this year's audit.
- Consider the work of internal audit.
- Inquire of management as to their assessment of the risk that the interim financial statements might be affected by fraud.
- Inquire of management whether there have been any significant changes in business activity in the relevant period, and if so, their impact.
- Inquire of management about any significant changes to internal controls and the potential effect on preparing the interim financial information.
- Inquire of management how the interim financial information has been prepared and the reliability of the underlying accounting records.
- Read the minutes of meetings of shareholders, those charged with governance and other appropriate committees.
- Consider the effect of matters giving rise to a modification of the audit or review report, accounting adjustments or unadjusted misstatements from previous audits.
- Where relevant, communicate with other auditors auditing different components of the business.
- Design and perform analytical procedures which will identify relationships and unusual items that may indicate a material misstatement.
- Read the interim financial information and considering whether anything has come to the auditors’ attention which suggests that it is not prepared in accordance with the applicable financial reporting framework.
- Agree the interim financial information to the underlying accounting records.
- The auditor should consider their suitability to accept the assignment: independence, competence, available time to carry out the extent of work and so on.

### Evidence

The auditor shall perform the following:

- Document significant matters.
- Use professional judgment and experience in determining nature, timing and extent of procedures.
- Inquire about subsequent events.
- Undertake further procedures if material misstatements are suspected.
1.1.4 Procedures

In a review engagement, the auditor will rely more heavily on procedures such as enquiry and analytical review than on more detailed substantive testing such as testing accounting records through inspection, observation or confirmation. There are two reasons for this:

1. He is seeking a lower level of assurance than for an audit, so these forms of evidence are sufficient due to risk being lower.

2. Such techniques provide indicators to direct work to risk areas and from which to draw conclusions; they are quick and, therefore, cost-effective.

(a) Inquiries

What the inquiries are about and what matters are the subject of analytical procedure will depend on the specific situation. Inquiries are primarily made to persons responsible for financial and accounting matters.

Auditors should make inquiries of members of management responsible for financial and accounting matters about:

(i) whether the interim financial information has been prepared and presented in accordance with the applicable financial reporting framework;
(ii) whether there have been changes in accounting policies;
(iii) whether new transactions have required changes in accounting principle;
(iv) whether there are any known uncorrected misstatements;
(v) whether there have been unusual or complex situations, such as disposal of a business segment;
(vi) significant assumptions relevant to fair values;
(vii) whether related party transactions have been accounted and disclosed correctly;
(viii) significant changes in commitments and contractual obligations;
(ix) significant changes in contingent liabilities including litigation or claims;
(x) compliance with debt covenants;
(xi) matters about which questions have arisen in the course of applying the review procedures;
(xii) significant transactions occurring in the last days of the interim period or the first days of the next;
(xiii) knowledge or suspicion of any fraud;
(xiv) knowledge of any allegations of fraud;
(xv) knowledge of any actual or possible non-compliance with laws and regulations that could have a material effect on the interim financial information;
(xvi) whether all events up to the date of the review report that might result in adjustment in the interim financial information have been identified; and
(xvii) whether management has changed its assessment of the entity being a going concern.

The auditor should obtain written representations from management that it acknowledges its responsibility for the design and implementation of internal control, that the interim financial information is prepared and presented in accordance with the applicable financial reporting framework and that the effect of uncorrected misstatements are immaterial (a summary of these should be attached to the representations). Also that all significant facts relating to frauds or non-compliance with law and regulations has been disclosed to the auditor and that all significant subsequent events have been disclosed to the auditor.
The auditor should read the other information accompanying the interim financial information to ensure that it is not inconsistent with it.

If the auditors believe a matter should be adjusted in the financial information, they should inform management as soon as possible. If management does not respond within a reasonable time, then the auditors should inform those charged with governance. If they do not respond, then the auditor should consider whether to modify the report or to withdraw from the engagement and the final audit if necessary. If the auditors uncover fraud or non-compliance with laws and regulations, they should communicate that promptly with the appropriate level of management. The auditors should communicate matters of interest arising to those charged with governance.

(b) Analytical procedures

The practitioner should perform an in-depth analytical review of the statement of comprehensive income and statement of financial position and document all work done to support the conclusion.

The following are some examples of analytical procedures to be performed:

(i) Comparing the interim financial statements/information with the interim financial statements/information of the immediately preceding interim period, with the interim financial statements/information of the corresponding interim period of the preceding financial year, with the interim financial statements/information that was expected by management for the current period, and with the most recent audited annual financial statements.

(ii) Comparing current interim financial statements/information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes to pretax income in the current interim financial statements/information with corresponding information in (a) budgets, using expected rates, and (b) financial statements/information for prior periods).

(iii) Comparing current interim financial statements/information with relevant non-financial information.

(iv) Comparing the recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and applying relationships that are reasonably expected to exist based on the auditor's understanding of the entity and of the industry in which the entity operates.

(v) Comparing ratios and indicators for the current interim period with those of entities in the same industry.

(vi) Comparing relationships among elements in the current interim financial statements/information with corresponding relationships in the interim financial statements/information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.

(vii) Comparing disaggregated data.

(c) Other procedures

In particular, HKSRE 2410 specifically requires the following procedures:

(i) Obtain evidence that the interim financial statements agrees or reconciles with the underlying accounting records;

(ii) Inquire whether management has identified all events up to the date of the review report and consider the requirement of making adjustment and disclosures;

(iii) Inquire whether management has changed its assessment of the entity's ability to continue as a going concern;
(iv) When the auditor becomes aware of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall:
   – inquire of management regarding future plans
   – consider the adequacy of disclosure

(v) When the auditor becomes aware that a material adjustment must be made for the interim financial statements, the auditor shall make additional inquiries and perform other possible procedures; and

(vi) When uncorrected misstatements have come to the auditor's attention, the auditor shall evaluate whether the uncorrected misstatements are material to the interim financial statements.

In addition, he should apply professional judgment in determining the specific nature, extent and timeliness of the procedures and consider subsequent events for adjustments and disclosures.

1.1.5 Additional procedures for incoming auditor

An incoming auditor should pay more attention to the following additional procedures:

(a) Obtaining knowledge of the business
(b) Assessing the inherent risk of misstatement
(c) Inquiring of predecessor or reviewing predecessor auditor's documents for the preceding annual audit
(d) Considering the nature of any corrected misstatements, significant risks, significant accounting and reporting matters such as any overriding of controls by management or internal control weaknesses

1.1.6 Reporting

An external review is an exercise similar to an audit, which is designed to give a reduced degree of assurance concerning the proper preparation of a set of financial statements.

Negative assurance is given on review assignments.

The review report should contain a clear written expression of negative assurance. The practitioner should review and assess the conclusion drawn from the evidence obtained as the basis for the expression of negative assurance.

Based on the work performed, the practitioner should assess whether any information obtained during the review indicates that the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects,' ) in accordance with the applicable financial reporting framework.

Key term

Negative assurance is assurance of something in the absence of any evidence arising to the contrary. In effect, this means the auditor is saying, 'I believe that this is reasonable because I have no reason to believe otherwise.'

HKSRE 2410 requires that:

(a) if the interim financial statements comprise a complete set of general purpose financial statements prepared in accordance with a financial reporting framework designed to achieve fair presentation, the review should contain a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information does not give a true and fair view, or does not present fairly, in all material respects, in accordance with the applicable financial reporting framework; and
(b) in other circumstances, a conclusion as to whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

Unqualified review report

When no matters have come to the attention of the auditor, he should give a clear expression of negative assurance in his report. An example of an unqualified review report is given in the appendix to the HKSRE, and it is reproduced here.

Report on Review of Interim Financial Information
(Appropriate addressee)

Introduction

We have reviewed the interim financial information set out on pages 10 to 20 which comprise the condensed statement of financial position of ABC Entity as of 30 June 2010 and the related condensed statement of comprehensive income, statement of changes in equity and statement of cash flows for the six-month period then ended, and a summary of significant accounting policies and other explanatory notes. The directors are responsible for the preparation and presentation of this interim financial information in accordance with Hong Kong Financial Reporting Standards. Our responsibility is to express a conclusion on this interim financial information based on our review.

Scope of Review

We conducted our review in accordance with Hong Kong Standard on Review Engagements 2410, ‘Review of Interim financial Information performed by the Independent Auditor of the Entity’ issued by the Hong Kong Institute of Certified Public Accountants. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Hong Kong Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

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

AUDITOR
Date
Address

Modified review report

Auditors should modify the review report in the following circumstances:

<table>
<thead>
<tr>
<th>Modification</th>
<th>Situation</th>
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<tr>
<td>Express a qualified or adverse conclusion</td>
<td>When a matter has come to the auditor's attention that causes the auditor to believe that a material adjustment should be made to the interim financial information for it to be prepared, in all material respects, in accordance with the applicable financial reporting framework; or If a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information. The report should include specific reference to the fact that there is such a material uncertainty.</td>
</tr>
</tbody>
</table>
Modification | Situation
--- | ---
Add an emphasis of matter paragraph | To highlight a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern, provided that adequate disclosure is made in the interim financial information; and

Consider modifying the review report by adding a paragraph to highlight a significant uncertainty (other than a going concern problem) that came to the auditor's attention, the resolution of which is dependent upon the future events and which may affect the interim financial information.

The auditor shall communicate in writing to the appropriate level of management and to those charged with governance, if the auditor is unable to complete the review, the reason why the review cannot be completed, and consider whether it is appropriate to issue a report.

Extract of review reports with a qualified conclusion for a departure from the applicable financial reporting framework

Basis for Qualified Conclusion

Based on information provided to us by the directors, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalised to conform with [indicate applicable financial reporting framework]. This information indicates that if these lease obligations were capitalised at 31 March 2010, property would be increased by $……….., long-term debt by $……….., and net income and earnings per share (basic and diluted) would be increased (decreased) by $……….., $……….., and $……….., respectively, for the six-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the interim financial statements does not give a true and fair view of (or “does not present fairly, in all material respects,”) the financial position of the entity as at 31 March 2010, and of its financial performance and its cash flows for the six-month period then ended in accordance with [indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards].

Extract from review reports with an adverse conclusion for a departure from the applicable financial reporting framework

Basis for Adverse Conclusion

Commencing this period, the directors of the entity ceased to consolidate the financial statements of its subsidiary companies since the directors consider consolidation to be inappropriate because of the existence of new substantial non-controlling interests. This is not in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards]. Had consolidated financial statements been prepared, virtually every account in the interim financial statements would have been materially different.

Adverse Conclusion

Our review indicates that, because the entity's investment in subsidiary companies is not accounted for on a consolidated basis, as described in the preceding paragraph, this interim financial statements does not give a true and fair view of (or “does not present fairly, in all material
respects,') the financial position of the entity as at 31 March 2010, and of its financial performance and its cash flows for the six-month period then ended in accordance with [indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards or International Financial Reporting Standards].

Extract of review reports with a qualified conclusion for a departure from the applicable financial reporting framework

Previous paragraphs as per standard report.

Basis for Qualified Conclusion

Based on information provided to us by management, ABC Entity has excluded from property and long-term debt certain lease obligations that we believe should be capitalised to conform with (indicate applicable financial reporting framework). This information indicates that if these lease obligations were capitalised at 31 March 2010, property would be increased by $ .........., long-term debt by $ .........., and net income and earnings per share would be increased (decreased) by $ .........., $ .........., $ .........., and $ .........., respectively for the three-month period then ended.

Qualified Conclusion

Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that caused us to believe that the accompanying interim financial information does not give a true and fair view of (or ‘does not present fairly, in all material respects,’) the financial position of the entity as at 31 March 2010, and of its financial performance and its cash flows for the three-month period then ended in accordance with (indicate applicable financial reporting framework, including the reference to the jurisdiction or country of origin of the financial reporting framework when the financial reporting framework used is not Hong Kong Financial Reporting Standards).

AUDITOR

Date

Address

Review report: Limitation on scope not imposed by management

Introduction paragraph – as per standard report

Scope paragraph

Except as explained in the following paragraph .... – as per standard report.

Basis for Qualified Conclusion

As a result of a fire in a branch office on (date) that destroyed its accounts receivable records, we were unable to complete our review of accounts receivable totalling $ included in the interim financial information. The entity is in the process of reconstructing these records and is uncertain as to whether these records will support the amount shown above the related allowance for uncollectible accounts. Had we been able to complete our review of accounts receivable, matters might have come to our attention indicating that adjustments might be necessary to the interim financial information.

Qualified Conclusion

Except for the adjustments to the interim financial information that we might have become aware of had it not been for the situation described above, based on our review, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view of (or ‘does not present fairly, in all material respects,’) the financial position of the entity as at 31 March 2010, and of its financial performance and its cash flows for the three-month period then ended in accordance with (indicate applicable financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting framework, including a reference to the jurisdiction or country of origin of the financial reporting
Self-test question 1

Jackson CPA is the auditor for Sparkle Jewellery Limited and is also appointed to review and report on the interim financial report of Sparkle Jewellery for the six months ended 30 June 20Y0. How does a review of an interim financial report differ from an audit of financial statements?  (The answer is at the end of the chapter)

1.2 Assurance assignments applied to review

There are two types of assurance engagements which can be applied to reviews since these are a type of assurance service:

(a) An **attestation** engagement where the accountant declares that a given premise is either correct or not.

(b) A **direct reporting** engagement, where the accountant reports on issues that have come to his attention during the course of his review.

**Example: Attestation engagement**

Auditors may sometimes be asked to review interim financial information. In such an engagement, the auditor is being asked to attest assertions made, such as:

(a) The accounting policies used are consistent with those used in the prior year financial statements.

(b) No material modifications to the interim financial information as it has been presented are required.

(c) Review procedures to secure compliance with quality control requirements.

**Example: Direct reporting engagement**

A direct reporting engagement is where the accountant reports on issues that have come to his attention during the course of the review. An example of a direct reporting engagement is a 'due diligence' engagement.
Key term

Due diligence reviews are a specific type of review engagement. A typical due diligence engagement is where an advisor (often an audit firm) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts. This is important when determining purchase price. Similarly, due diligence can also be requested by sellers. When a company is taken over or merged, all parties need to be assured that what is purported to be actually is. It can be carried out by actuaries, surveyors or lawyers. Normally, a takeover is not completed until a due diligence report has been completed.

It may include some or all of the following aspects:

(a) Financial due diligence (a review of the financial position and obligations of a target to identify such matters as covenants and contingent obligations)
(b) Operational and IT due diligence (extent of operational and IT risks, including quality of systems, associated with a target business)
(c) People due diligence (key staff positions under the new structure, contract termination costs and cost of integration)
(d) Regulatory due diligence (review of the target's level of compliance with relevant regulation)
(e) Environmental due diligence (environmental, health and safety and social issues in a target)

1.3 Agreed-upon procedures

Topic highlights

In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

Key term

Agreed-upon procedures assignment. In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The recipients of the report must form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. No assurance will be expressed on the financial information.

Agreed-upon procedures assignments are discussed in HKSRS 4400 Engagements to Perform Agreed-upon Procedures Regarding Financial Information.

1.3.1 Accepting appointment

The auditor should ensure with representatives of the entity, and ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.
1.3.2 Carrying out procedures and reporting

The auditor should have complied with HKICPA's Professional Ethics Statements and should agree an engagement letter with the clients stating the agreed upon procedures to be performed, and that the distribution of the report of factual findings is restricted to the specified parties.

The auditors should plan the assignment. They should carry out the agreed-upon procedures, documenting their process and findings.

The report of factual findings should contain:

(a) Title
(b) Addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures)
(c) Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied
(d) A statement that the procedures performed were those agreed upon with the recipient
(e) A statement that the engagement was performed in accordance with the International Standard on Auditing applicable to agreed-upon procedure engagements, or with relevant national standards or practices
(f) When relevant, a statement that the auditor is not independent of the entity
(g) Identification of the purpose for which the agreed-upon procedures were performed
(h) A listing of the specific procedures performed
(i) A description of the auditor's factual findings including sufficient details of errors and exceptions found
(j) Statement that the procedures performed do not constitute either an audit or a review, and, as such, no assurance is expressed
(k) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported
(l) A statement that the report is restricted to those parties that have agreed to the procedures to be performed
(m) A statement, when applicable, that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole
(n) Date of the report
(o) Auditor's address
(p) Auditor’s signature

Self-test question 2

Gourmet Ltd operates a number of restaurants across Hong Kong. The directors of Gourmet Ltd are concerned that a number of their company’s purchasers have participated in a 'kick-back’ arrangement with the suppliers, in which the purchasers receive an incentive to place an order with a particular supplier. Gourmet Ltd is currently in a position open to manipulation as they normally focus on high quality ingredients regardless of the season or supplier. Hence, supply of ingredients has never been maintained from one particular area. In the past, Gourmet has relied on the integrity of its purchasers, but recently concerns have been expressed about the seafood purchaser as the quality of the seafood has deteriorated and the supplier chosen has always been the same one with little reasons explained.

In order to ensure the independence of the enquiry, the directors have contacted your firm, ABC & Co, to perform some special investigation work. Gourmet Ltd has requested you to investigate the
purchasing procedures between the purchasers and the suppliers. Gourmet Ltd has supplied with you purchase orders for the past three months, delivery notes, the firm's policy and procedures manual and a list of suppliers used.

**Required**

Write a memorandum to the directors of Gourmet Ltd in connection with the special engagement. You should include:

(i) the scope and nature of the work, including the relevant standards your firm would follow;
(ii) specific procedures your firm agrees (or proposes) to perform; and
(iii) key elements in your firm's report.

(The answer is at the end of the chapter)

### 1.3.3 Operational audits

Operational audits are different to compliance audits in that the scope is more extensive. As part of an operational audit, an internal audit department might undertake a compliance audit, but the scope also includes an assessment of the effectiveness of the procedures that are being audited.

As such, an operational audit is more like an agreed-upon procedures engagement. While an element of assurance is given (particularly with regard to the compliance elements of the assignment), the audit is designed with the intention of the internal auditor drawing his own conclusions about the systems from the work he has done.

### 1.4 Compilations

**Topic highlights**

In a compilation engagement, the accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarise financial information.

**Key term**

**Compilation engagement.** In a compilation engagement, the accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarise financial information. No assurance will be expressed on the financial information.

A compilation engagement is one where the accountant is engaged to compile information. Users will obtain some benefits because professional accountants carry out their works with professional competence and due care. Examples include:

- preparing financial statements
- preparing tax returns

The information to be compiled does not have to be financial information.

The guidance on compilation engagements is found in HKSRS 4410 *Engagements to Compile Financial Statements*.

**1.4.1 General principles of a compilation engagement**

HKSRS 4410 identifies two principles:

(a) The accountant should comply with the HKICPA’s *Professional Ethics Statements*.  
   (Independence is not a requirement for a compilation engagement.)
(b) In all circumstances when an accountant's name is associated with financial information compiled by the accountant, the accountant should issue a report.

### 1.4.2 Procedures

The following procedures are normally performed by the professional accountant:

(a) Agree an engagement letter with the client: ie not an audit or review, no reliance on discovered errors, responsible for accuracy, basis of accounting, form of report.

(b) Gain a general knowledge of the business and be familiar with the accounting principles and practices of the client's industry and the form and content of the financial information.

(c) The professional accountant should read the compiled information and consider whether it appears to be appropriate in form and free from obvious misstatements. The professional accountant should discuss with management amendments to financial information when aware of material misstatements. If management insist on no alteration and the professional accountants should consider the financial information misleading, withdraw from the engagement.

(d) The professional accountant can request management to provide additional information and if management refuses, the professional accountant should withdraw from the engagement.

(e) The professional accountant should perform limited procedures such as analytical review and inquiry of management.

(f) The professional accountant should obtain an acknowledgement from management for the appropriate presentation of financial information and its approval of financial information.

(g) The professional accountant should make a report on the compiled financial information which contains a reference such as 'unaudited', 'compiled without Audit or Review'.

### 1.4.3 Reporting

The information compiled by the accountant should contain a reference to the fact that it has not been audited.

Reports on compilation engagements should contain the following:

(a) Title

(b) Addressee

(c) A statement that the engagement was performed in accordance with the HKSA applicable to compilation engagements, or with national standards and practices

(d) When relevant, a statement that the accountant is not independent of the entity

(e) Identification if the financial information noting that it is based on information provided by management

(f) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information

(g) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework

(h) Date of the report

(i) Accountant's address

(j) Accountant's signature
2 Other assurance engagements

Topic highlights
Assurance engagements should only be accepted if the firm meets the requirements of the Code of Ethics for Professional Accountants and HKQC 1.

2.1 Assurance engagements other than audit and review of historical financial information

Here, we shall focus on assurance engagements on subjects other than historical financial information (which we have already looked at in the form of audits and reviews) as we look at the guidance in HKSAE 3000 Assurance Engagements other than Audits or Reviews of Historical Financial Information.

Ethical requirements, quality control procedures and engagement acceptance should be considered.

The practitioner should assess the appropriateness of the subject matter and suitability of the criteria to evaluate or measure the subject matter.

The practitioner should plan the engagement and perform the engagement with an attitude of professional scepticism.

In addition, the following should be performed:
(a) Obtain understanding of the subject matter
(b) Identify and assess the risk of the subject matter information being materially misstated and reduce the risk
(c) Consider materiality level
(d) Design and perform further evidence gathering procedures
(e) Obtain sufficient appropriate evidence to form a conclusion, evaluate at the end whether he has achieved the purpose
(f) Obtain relevant representations
(g) Document findings
(h) Consider need for an expert who has adequate skills and knowledge
(i) Written assurance report and qualification is required if there is any limitation on the scope or disagreement with management

2.1.1 Compliance audits

Compliance audits are the traditional realm of internal auditors. They involve having a knowledge of the entity’s policy and carrying out tests to ensure that the policy is being followed in practice. It is determined whether an entity has complied with specified policies, procedures, laws, therefore it requires established criteria. The accountant should determine the extent of compliance with these criteria.

As such, compliance audits tend to fall into the category of internal audit providing assurance services, as discussed above. This is because management are employing them to give them assurance that certain criteria have been met.

For example:
PN860.2 Internal controls of investment custodians made available to third parties
PN810.1 Insurance brokers’ compliance with Insurance Authority or review of annual financial reports of a non-governmental organisation

The engagement may be performed by independent auditors, external auditors or internal auditors and government auditors.

### 2.1.2 Performance audit (Value for money audits) (VFM)

The assessment of economy, efficiency and effectiveness should be a part of the normal process of any entity, public or private. Management should carry out performance reviews as a regular feature of their control responsibilities.

In a VFM audit, the objectives of a particular programme or activity need to be specified and understood in order for a proper assessment of whether value for money has been achieved to be made.

(a) In a profit-seeking entity, objectives can be expressed financially in terms of target profit or return. The entity, and profit centres within it, can be judged to have operated effectively if they have achieved a target profit within a given period. Shareholders might be interested in value for money.

(b) In non-profit seeking entities, effectiveness cannot be measured this way, because the entity has non-financial objectives. The effectiveness of performance in such entities could be measured in terms of whether targeted non-financial objectives have been achieved, but as we have seen there are several problems involved in trying to do this. In a non profit-targeted entity, value for money can be extremely important. Interested parties (stakeholders) might be trustees and donors. In this case, criteria would be objectives set within the system.

Public sector entities are now under considerable pressure to prove that they operate economically, efficiently and effectively, and are encouraged from many sources to draw up action plans to achieve VFM as part of the continuing process of good management.

VFM is important whatever level of expenditure is being considered. Negatively, it may be seen as an approach to spreading costs in public expenditure fairly across services but positively it is necessary to ensure that the desired impact is achieved with the minimum use of resources. Therefore, VFM audits are normally conducted by government auditors on government entities.

### Program audits

Consideration should be given to:

- the extent of desired results or benefits established by authorising body
- effectiveness of programs, activities or functions
- whether entity has complied with significant laws or regulations

### Effective or efficient audit

Consideration should be given to:

- whether the entity has acquired, protected and used the resources economically and efficiently
- causes of inefficiencies and in effectiveness
- whether the entity has complied with laws and regulations economically and effectively
3 Pro forma financial information in investment circular reporting engagements

_HKSIR 300 Accountants’ Reports on Pro Forma Financial Information in Investment Circulars_

Under HKSIR 300, reporting accountants should issue a report containing a clear expression of opinion on the pro forma financial information.

**Pro forma financial information** is included in the investment circular to show information about the transaction that is subject to investment circular by showing how it might have affected financial information of the issuer if the transactions have been undertaken at the commencement of the financial period used for the illustration.

In the engagement to report on pro forma financial information in the investment circular, the reporting accountant should comply with HKSIR 300, HKSQC 1 and any relevant HKSAs, HKAEs and in particular, HKSA 220.

Reporting accountants should obtain sufficient appropriate evidence to form basis for their opinion on the pro forma financial information.

4 Preliminary announcement of annual results

_PN 730 Guidance for Auditors Regarding Preliminary Announcements of Annual Results_

This is the first public communication of listed entities full year results and year-end financial position.

The directors have obligations under the Listing Rules that the preliminary announcement of results for the financial year shall have been agreed with the issuer’s auditors before being published.

PN 730 dictates the auditor’s procedures and reporting the outcome of such procedures to the directors. Auditors should perform an agreed-upon procedures engagement.

The listed company is also required to provide additional information to accompany its preliminary announcement of results. Auditors are not required to report on the additional information to accompany the preliminary announcement of results.

5 Comfort letters and due diligence meetings on financial and non-financial information

_HKSIR 400 Comfort Letters and Due Diligence Meetings on Financial and Non-Financial Information_

According to HKSIR 400, no assurance is expressed in a comfort letter or due diligence meeting on financial or non-financial information.

HKSIR 400 requires that, in providing a comfort letter and formulating responses to questions asked by sponsors, reporting accountants should note that:

(a) only the sponsors can determine what is sufficient for a reasonable due diligence investigation

(b) the sponsors can rely on any statements made by the reporting accountant

(c) the reporting accountant needs to possess adequate knowledge on the subject matters before making any statements and act with due care and with an objective mind

(d) there must be supporting evidence to support the statements made

For any statements made, reporting accountants are adding credibility to the statements, therefore when providing comfort letter or participating in due diligence meetings in financial and
non-financial information, procedures should be undertaken only to matters where professional competence is relevant and is conducted according to HKSIR 400.

When conducting engagements under HKSIR 400, the reporting accountant should apply agreed-upon procedures and his report should contain the procedures carried out and the findings. No positive or negative assurance should be given.

Only the sponsors can determine the information on which the comfort letter is required and the procedures that will provide the required degree of comfort on that information.

6 Engagements to report on summary financial statements

HKSA 810 Engagements to Report on Summary Financial Statements is a new standard that governs the engagement to report on summary financial statements and is effective for engagements for periods beginning on or after 15 December 2009.

The objectives of the standard are to assist auditors to determine whether it is appropriate to accept the engagement to report on summary financial statements and to form an opinion on the summary financial statements based on an evaluation of the conclusion drawn from the evidence obtained to express clearly that opinion through a written report that also describes the basis for that opinion.

Key terms

Applied criteria. The criteria applied by management in the preparation of the summary financial statements.

Summary financial statements. Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity’s economic resources or obligations at a point in time or the changes therein for a period of time.

6.1 Engagement acceptance

The auditor shall accept an engagement to report on summary financial statements in accordance with this HKSA only when the auditor has been engaged to conduct an audit in accordance with HKSAs of the financial statements from which the summary financial statements are derived.

Before accepting an engagement to report on summary financial statements, the auditor shall:

(a) determine whether the applied criteria are acceptable
(b) obtain the agreement of management that it acknowledges and understands its responsibility:
   (i) for the preparation of the summary financial statements in accordance with the applied criteria
   (ii) to make the audited financial statements available to the intended users of the summary financial statements without undue difficulty
   (iii) to include the auditor's report on the summary financial statements in any document that contains the summary financial statements and that indicates that the auditor has reported on them
(c) agree with management the form of opinion to be expressed on the summary financial statements
The auditor shall not accept the engagement to report on the summary financial statements, if the auditor concludes that the applied criteria are unacceptable or is unable to obtain the agreement of management.

6.2 Engagement procedures

The auditor shall perform the following procedures, and any other procedures that the auditor may consider necessary, as the basis for the auditor's opinion on the summary financial statements:

(a) Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements.

(b) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly:
   (i) From whom or where the audited financial statements are available; or
   (ii) The law or regulation that specifies that the audited financial statements need not be made available to the intended users of the summary financial statements and establishes the criteria for the preparation of the summary financial statements.

(c) Evaluate whether the summary financial statements adequately disclose the applied criteria.

(d) Compare the summary financial statements with the related information in the audited financial statements to determine whether the summary financial statements agree with or can be recalculated from the related information in the audited financial statements.

(e) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria.

(f) Evaluate, in view of the purpose of the summary financial statements, whether the summary financial statements contain the information necessary, and are at an appropriate level of aggregation, so as not to be misleading in the circumstances.

(g) Evaluate whether the audited financial statements are available to the intended users of the summary financial statements without undue difficulty, unless law or regulation provides that they need not be made available and establishes the criteria for the preparation of the summary financial statements.

6.3 Form of opinion

When the auditor has concluded that an unmodified opinion on the summary financial statements is appropriate, the auditor's opinion shall, unless otherwise required by law or regulation use one of the following phrases:

(a) The summary financial statements are consistent, in all material respects, with the audited financial statements, in accordance with (the applied criteria); or

(b) The summary financial statements are a fair summary of the audited financial statements, in accordance with (the applied criteria).

If law regulation prescribes the wording of the opinion on summary financial statements differently, the auditor should:

(a) apply further procedures necessary to enable the auditor to express the prescribed opinion; and

(b) evaluate whether users of the summary financial statements might misunderstand the auditor's opinion on the summary financial statements and, if so, whether additional explanation in the auditor's report on the summary financial statements can mitigate possible misunderstanding. The auditor shall not accept an engagement where possible mitigation of misunderstandings cannot be carried out.
6.4 Report date
The auditor's report on the summary financial statements may be dated later than the date of the auditor's report on the audited financial statements. The report should state when the summary does not reflect the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements that may require adjustment of, or disclosure in, the audited financial statements. Therefore, subsequent event review under HKSA 560 (Clarified) is still required to be performed.

6.5 Elements of the auditor's report
The auditor's report on summary financial statements shall include the following elements:

(a) A title clearly indicating it as the report of an independent auditor

(b) An addressee – the auditor shall evaluate the appropriateness of using a different addressee if the addressee of the summary financial statements is not the same as the addressee of the auditor's report on the audited financial statements

(c) An introductory paragraph that:

(i) identifies the summary financial statements on which the auditor is reporting, including the title of each statement included in the summary financial statements;

(ii) identifies the audited financial statements;

(iii) refers to the auditor's report on the audited financial statements, the date of that report, and the fact that an unmodified opinion is expressed on the audited financial statements;

(iv) if the date of the auditor's report on the summary financial statements is later than the date of the auditor's report on the audited financial statements, states that the summary financial statements and the audited financial statements do not reflect the effects of events that occurred subsequent to the date off the auditor's report on the audited financial statements; and

(v) includes a statement indicates that the summary financial statements do not contain all the disclosures required by the financial reporting framework applied in the preparation of the audited financial statements, and that reading the summary financial statements is not a substitute for reading the audited financial statements.

(d) a description of management's responsibility for the summary financial statements, explaining that management is responsible for the preparation of the summary financial statements in accordance with the applied criteria

(e) a statement that the auditor is responsible for expressing an opinion on the summary financial statements based on the procedures required by this HKSA

(f) a paragraph clearly expressing an opinion

(g) the auditor's signature

(h) the date of the auditor's report. The auditor shall date the auditor's report on the summary financial statements no earlier than: the date on which the auditor has obtained sufficient appropriate evidence on which to base the opinion or the date of the auditor's report on the audited financial statements

(i) the auditor's address
6.6 Modified report

6.6.1 Emphasis of matter paragraph

When the auditor's report on the audited financial statements contains a qualified opinion, an emphasis of matter paragraph, or an other matter paragraph, but the auditor is satisfied that the summary financial statements are consistent, in all material respects, with or are a fair summary of the audited financial statements, in accordance with the applied criteria, the auditor's report on the summary financial statements shall, in addition to the elements in paragraph:

(a) State that the auditor's report on the audited financial statements contains a qualified opinion, an emphasis of matter paragraph, or an other matter paragraph; and

(b) Describe:

(i) the basis for the qualified opinion on the audited financial statements, and that qualified opinion; or the emphasis of matter or the other matter paragraph in the auditor's report on the audited financial statements; and

(ii) the effect thereof on the summary financial statements, if any.

6.6.2 Adverse opinion or a disclaimer opinion

When the auditor's report on the audited financial statements contains an adverse opinion or a disclaimer of opinion, the auditor's report on the summary financial statements shall, in addition to the elements:

(a) State that the auditor's report on the audited financial statements contains an adverse opinion or disclaimer of opinion;

(b) Describe the basis for that adverse opinion or disclaimer of opinion; and

(c) State that, as a result of the adverse opinion or disclaimer of opinion, it is inappropriate to express an opinion on the summary financial statements.

If the summary financial statements are not consistent, in all material respects, with or are not a fair summary of the audited financial statements, in accordance with the applied criteria, and management does not agree to make the necessary changes, the auditor shall express an adverse opinion on the summary financial statements.

6.6.3 Restriction on distribution or use or alerting readers to the basis of accounting

The auditor shall include a similar restriction or alert in the auditor's report on the summary financial statements when distribution or use of the auditor's report on the audited financial statements is restricted, or the auditor's report on the audited financial statements alerts readers that the audited financial statements are prepared in accordance with a special purpose framework.

6.7 Comparatives and supplementary information

When the summary financial statements do not contain comparatives but the audited financial statements contain such comparatives, the auditor shall determine the effect of an unreasonable omission on the auditor's report on the audited financial statements.

If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that requires the auditor to include in the auditor's report on the audited financial statements.

The auditor shall evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements.

For any unaudited supplementary information presented with the summary financial statements that is clearly differentiated from the summary financial statements, the auditor shall ask
management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report.

For any other information included in a document containing the summary financial statements, auditors should read the information and consider the inconsistencies.

6.8 Auditor association

The auditor shall request management to include the auditor's report if they become aware of any document containing the summary financial statements on which they have reported but where management does not intend to include the related auditor's report. If management refuses, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document.

When auditors are engaged to report on the summary financial statements and the entity plans to make a statement in a document that refers to the auditor, the auditor should be satisfied that the reference to the auditor is made in the context of the auditor's report on the audited financial statements and the statement does not give the impression that the auditor has reported on the summary financial statements.
Audit-related services and other assurance engagements | Part E Other audit matters

### Topic recap

- Audit-related services may be assurance services (reviews) or not (agreed-upon procedures and compilations).
- Assurance services improve the quality of decision-making for users of information.
- Assurance engagements may give reasonable assurance or limited assurance.
- In a compilation engagement, the accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarise financial information.
- Assurance engagements should only be accepted if the firm meets the requirements of the Code of Ethics for Professional Accountants and HKSQC 1.
- A review provides a **limited level** of assurance that the information subject to review is free of material misstatement. The review is expressed in the form of **negative assurance**.
- In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures to which the auditor and the entity and any appropriate third parties have agreed and to report on **factual findings**.
Answer 1

As per HKSRE 2410, the objective of a review of interim financial report is to enable the auditor to express a conclusion whether anything has come to his attention that causes him to believe that the interim financial report is not prepared, in all material respects, in accordance with HKAS 34 Interim Financial Reporting.

A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial report is free from material misstatement. A review provides limited assurance.

A review consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

A review may bring significant matters affecting the interim financial report to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

Answer 2

Memorandum

To: Directors of Gourmet Ltd
From: xxx of ABC & Co
Date: xx/xx/20X8
Re: Proposed agreed-upon procedures engagement

With regard to the proposed engagement we have discussed previously, this memorandum is to clarify our understanding of the terms and objectives of the engagement and the nature and limitations of the services that we will provide.

Our engagement will be conducted in accordance with Hong Kong Standards on Related Services 4400, Engagements to Perform Agreed-Upon Procedures Regarding Financial Information issued by the Hong Kong Institute of Certified Public Accountants.

I understand that you expect us to investigate the purchasing procedures between the purchasers and suppliers of your company.

For these purposes, we propose to perform the following procedures and report to you the factual findings resulting from our work.

Regarding the investigation of the purchasing procedures, we may:

1. Review all purchase orders for a three-month period and ensure terms and conditions are within guidelines specified in the policy and procedures manual.
2. Circularize all suppliers found in the period to confirm terms of trade and quantity of goods delivered.
3. Agree purchase orders with deliver notes and supplier invoices.
4. Observe delivery procedures and ensure they are in line with procedures documented in the firm's policy and procedures manual.
5. Inspect all agreements made between the purchasers and suppliers

The procedures that we will perform will not constitute an assurance engagement made in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the Hong Kong Institute of CPAs and, consequently, no assurance will be expressed. The procedures that we will
perform are solely to assist you in the investigation of the purchasing procedures by your purchasers. Our report is not to be used for any other purpose and is solely for your information.

In our report, we will, amongst other items:

1. List the specific procedures we have performed;
2. Provide a description of our factual findings including sufficient details of errors and exceptions found;
3. State that the procedures performed do not constitute an assurance engagement and, as such, no assurance is expressed;
4. State that had we performed additional procedures or an assurance engagement, other matters might have come to light that would have been reported;
5. State that the report is restricted to those parties that have agreed to the procedures to be performed.

We look forward to discussing details about this engagement with you so that we may send you a formal engagement letter.

Regards,
XXX
Micro

Micro is a small company which is not required to have a compulsory external audit. There are only three shareholders, all of whom are on the company's board of directors. In the past the company has not had an external audit because none of the interested parties have felt it necessary to have one on a voluntary basis.

Micro has approached its bank and asked for a substantial loan in order to fund an expansion. The bank has indicated that the application would be more likely to succeed if it was accompanied by an independent accountant's report that indicated that the statements gave a true and fair view and were a suitable basis for the loan decision. The directors of Micro have asked your firm to provide this report.

Required

(a) Identify the difficulties that might arise in planning and conducting the work requested by Micro. (12 marks)

(b) Explain the extent to which you might be liable to the bank for any alleged errors in the financial statements, assuming that you prepared the report requested by Micro. (8 marks)

(Total = 20 marks)
Part F

Computerised business systems

Computerised business systems are common nowadays when internet technology and culture developed rapidly over the last two decades. Virtually no assurance process could be completed without a proper consideration and assessment of the computerised business systems involved. Students will learn from this Part the impact and relationship of computerised business systems and the assurance process.
topic list

1 Information technology audits
2 Electronic commerce
3 Computer-assisted audit techniques (CAATs)
4 Stand-alone computers
5 Online computer systems
6 Database systems
7 Intranets and extranets
8 IT internal audit

learning focus

Computers are vital to the functioning of the business therefore the use of IT is increasingly common in auditing. Auditors often perform audit procedures on automated controls for sophisticated e-commerce.

Computer-assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool. CAATs are an important tool in the audit and we examine the two main types of CAATs, audit software and test data.

It is most common for small entities to use stand-alone computers for their computer-based accounting system. Online computer systems are computer systems that enable users to access data and programs directly through terminal devices ie the Internet.

Database systems consist principally of two components: the database and the database management system (DBMS). A database’s general controls are the most important; therefore, auditors may find it more cost-effective to understand the database’s internal controls.
## Learning outcomes

In this chapter you will cover the following learning outcomes:

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<th>Learning outcome</th>
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<td>4.01</td>
<td><strong>Key features of a computerised business system</strong></td>
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<tr>
<td>4.01.01</td>
<td>Identify the characteristics of an entity operating a networked computer system</td>
</tr>
<tr>
<td>4.01.02</td>
<td>Identify the characteristics of an entity operating with standalone PCs</td>
</tr>
<tr>
<td>4.02</td>
<td><strong>Categories and types of controls:</strong></td>
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<tr>
<td>4.02.01</td>
<td>State examples of controls in a computerised system</td>
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<tr>
<td>4.02.02</td>
<td>Define and give examples of general and application controls</td>
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<tr>
<td>4.03</td>
<td><strong>Impact of increasing use and share of ownership by accountants in corporate information system</strong></td>
</tr>
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<td>4.04</td>
<td><strong>Impact of e-commerce:</strong></td>
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<tr>
<td>4.04.01</td>
<td>Recognise and discuss the importance of e-commerce to a business</td>
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<tr>
<td>4.04.02</td>
<td>Identify and explain the effect of e-commerce on the auditor’s risk assessment and audit approach</td>
</tr>
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<td>4.04.03</td>
<td>Identify the knowledge and skills required to audit an entity’s e-commerce activities</td>
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<tr>
<td>4.05</td>
<td><strong>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</strong></td>
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<td>4.06</td>
<td><strong>Risk and control framework:</strong></td>
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<tr>
<td>4.06.01</td>
<td>Explain the audit problems of an entity operating a networked computer system</td>
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<td>4.06.02</td>
<td>Explain the audit problems of an entity operating with standalone PCs</td>
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<td>4.07</td>
<td><strong>Internal audit:</strong></td>
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<tr>
<td>4.07.01</td>
<td>Explain the ways in which internal audit is of particular significance in a computerised accounting system</td>
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<td>4.07.02</td>
<td>Identify the procedures that an auditor may have to undertake to assess the role of internal audit</td>
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<td>4.08</td>
<td><strong>System change processes:</strong></td>
</tr>
<tr>
<td>4.08.01</td>
<td>Explain the potential impact on the auditor where an entity changes its computerised system</td>
</tr>
<tr>
<td>4.09</td>
<td><strong>Risk assessment and evaluation of IT processes:</strong></td>
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<tr>
<td>4.09.01</td>
<td>Identify what factors the auditor may need to consider in assessing the audit risk of a computerised environment</td>
</tr>
<tr>
<td>4.09.02</td>
<td>Describe the use of computer-assisted audit techniques (CAAT) in an audit</td>
</tr>
</tbody>
</table>
1 Information technology audits

**Topic highlights**

An information technology (IT) audit is a tests of controls in a specific area of the entity.

A huge number of entities now use computer systems to run their businesses, and financial information is processed on a computer system.

This means that a number of the controls which the directors are required to put into place to safeguard the assets of the shareholders are incorporated into computer systems.

An information technology (IT) audit is a tests of controls in a specific area of the business, the computer systems. Increasingly in modern business, computers are vital to the functioning of the entity, and therefore the controls over them are key to the business.

It is likely to be necessary to have an IT specialist in the internal audit team to undertake an audit of the controls, as some of them will be programmed into the computer system.

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

![Diagram showing various areas of IT in the entity](image)

The use of IT is increasingly common in auditing. There are several factors which may need to be considered:

- Whether the entity has a computerised system
- If so, whether the auditors will make use of CAATs
- Whether the auditor will use computers to complete his working papers
- If so, whether the members of the audit team are equipped with laptops
- What specific audit tasks the engagement partner requires to be done on the computer, for example, analytical review
- Whether the partner wants to be able to contact the audit team electronically on site; and
- If so, whether the audit team are properly equipped with modems.

**System reliability**

It is important to have reliable system of internal control for financial statements and general business operations. Stakeholders who are interested in information from the business will also have an implied interest in assurance on business systems.
2 Electronic commerce

Key terms

The Internet is a global network connecting millions of computers.

The World Wide Web is a system of Internet servers that support specially formatted documents. A group of documents accessed from the same base web site is known as a website.

Electronic data interchange (EDI) is a form of computer to computer data transfer. Information can be transferred in electronic form, avoiding the need for the information to be re-inputted somewhere else.

Electronic mail (e-mail) is a system of communicating with other connected computers or via the Internet in written form.

Electronic commerce (e-commerce) means conducting business electronically via a communications link.

The items described above are all now commonly used in business. You are probably familiar with most, if not all of them.

All the items discussed above are (or can be) used in e-commerce. As this is an exceedingly fast growing area of business, it is a very important area for everyone, including accountants, today. You should be familiar with the idea of e-commerce from your earlier studies.

A business can engage in ‘e-commerce’ to a great or small degree. The greater the involvement, the more the risk associated with the involvement. The extent of involvement is explored in the following table.

<table>
<thead>
<tr>
<th>Involvement</th>
<th>Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information provision: A website can be used as a marketing device, to provide information to potential customers, and to enable them to request further information through an e-mail link.</td>
<td>LOW</td>
</tr>
<tr>
<td>Transactions with existing customers. Existing customers can be given the opportunity to track current contracts or initiate others over the website.</td>
<td></td>
</tr>
<tr>
<td>Access to new customers. A website can be used as a place where new customers may initiate transactions with the company.</td>
<td></td>
</tr>
<tr>
<td>New business model. A website can be used to diversify into specific web-based products, for example, items that are ‘downloadable’.</td>
<td>HIGH</td>
</tr>
</tbody>
</table>

2.1 Entities that use e-commerce

Practice Note Electronic Commerce – Effect on the Audit of Financial Statements (PN 1013) provides guidance to auditors auditing entities that engage in e-commerce. The PN identifies specific matters to assist the auditor when considering the significance of e-commerce to the entity’s business and the effect on the auditor’s risk assessment.

The increasing use of the Internet for business to consumer, business to business, business to government and business to employee e-commerce is introducing new elements of risk to be addressed by the entity and considered by the auditors when planning and performing the audit of the financial statements. Growth of Internet activity without due attention by the entity to those risks may affect the auditors’ assessment of risk.
2.2 Skills and knowledge required to audit e-commerce

**Topic highlights**

The auditor needs to consider whether the skills and Internet business knowledge of team members are appropriate to perform the audit for e-commerce client's.

The auditor needs to consider whether the skills and Internet business knowledge of team members are appropriate to perform the audit, and also whether an expert is required. The auditors should consider how the work of the expert is integrated with the work of others on the audit, and what procedures are undertaken regarding risks identified through the expert's work.

The auditor also needs to have a good understanding of the business to assess the significance of e-commerce and its effect on audit risk. The auditor should consider the following:

(a) The client's business activities and industry; the auditor should develop knowledge of the economy and the industry within which the entity operates, new lines of business, delivery of digital products and so on

(b) The client's e-commerce strategy, for example, the alignment of e-commerce activities with the entity's overall business strategy, modifications on efficiency of existing products or for example, the new market development, management's evaluation or impact of e-commerce and management's attitudes to risks

(c) The technology used to facilitate the client's e-commerce activities

(d) The risks involved in the client's use of e-commerce

(e) The client's approach to managing those risks ie security infrastructure and related controls

(f) The extent of e-commerce activities ie provide information only, facilitate transactions with established customers, gain access to new markets and new customers, create an entirely new business model

(g) Outsourcing arrangements ie depend on service organisations such as Internet Service Providers (ISPs), Application Service Providers (ASPs) and data hosting companies

Auditors may use the knowledge obtained to determine the nature, timing and extent of audit procedures and evaluate audit evidence and consider the effect of the entity's dependence on e-commerce activities on its ability to continue as a going concern.

The following are industries that are being transformed by e-commerce:

- Computer software
- Securities trading
- Banking
- Travel services
- Books and magazines
- Recorded music
- Advertising
- News media
- Education
2.3 Business risks relating to e-commerce activities

**Topic highlights**

The auditor uses the knowledge of the entity gained to identify events, transactions and practices related to business risks arising from e-commerce activities that may result in material misstatements in the financial statements.

The Practice Note identifies specific business risks affecting entities that engage in e-commerce, which are outlined below:

- Loss of transaction integrity – lack of an adequate audit trail
- Pervasive e-commerce security risks – virus attacks or unauthorised access
- Improper accounting policies (e.g., capitalisation of expenditure, translation of foreign currency, allowances for warranties and returns, revenue recognition)
- Non-compliance with taxation and other laws and regulations – e-commerce activities are conducted across international boundaries
- Failure to ensure that contracts are binding
- Over-reliance on e-commerce
- Systems and infrastructure failures or crashes

The entity addresses certain business risks arising in e-commerce through the implementation of an appropriate security infrastructure and related controls.

How to reduce the above risks? Entities can implement the following:

- Ensure the integrity of transactions
- Obtain agreement on terms of trade
- Obtain payment from, or secure credit facilities for, customers
- Establish privacy and information protection protocols
- Verify the identity of customers and suppliers
- Consider legal and regulatory issues
- Adherence to national and international privacy requirements

2.3.1 The increasing risk of cyber incidents

Increasing connectivity and the openness of computer networks in the global business environment exposes businesses to system and network failures and to cyber attacks, resulting worldwide losses due to hostile attacks in a wide range like effects by worms and viruses. The cyber incidents had the effect of wiping off the share price of listed entities.

2.4 Internal controls

The auditor also considers the control environment and control procedures that are relevant to the financial statement assertions, in accordance with HKSA 315 (Clarified), in particular those relating to security, transaction integrity and process alignment.

Therefore in contrast to audit procedures for traditional business activities which focus separately on control processes relating to each stage of transaction processing, audit procedures for sophisticated e-commerce often focus on automated controls.

The security infrastructure and related controls can be expected to be more extensive where the website is used for transacting with business partners, or where systems are highly integrated.
2.4.1 Internal control systems

To recap, for assurance on internal controls systems, the accountant needs to focus on the design and operation of internal control systems.

The process of internal control system is outlined below:

(a) Identify business objectives
(b) Assess risks that will threaten those objectives
(c) Design internal controls to manage those risks
(d) Operate the internal controls in accordance with the design

Professional accountants will need to have sufficient knowledge of the entity that they can identify and understand the events, transactions and practices in order to test the assurance of the internal controls.

2.4.2 Security

The issue of security in e-commerce is extremely important. It is important for the business, as there is a more substantial risk of fraud being perpetrated against the company if transactions are carried out through the website rather than in person. It is important for the customer, particularly a private consumer, who is inputting sensitive personal data.

Information is secure to the extent that the requirements for its authorisation, authenticity, confidentiality, integrity, non-repudiation and availability have been satisfied.

The entity will ordinarily address security risks related to the recording and processing of e-commerce transactions through its security infrastructure and related controls. The security infrastructure and related controls may include an information security policy, an information security risk assessment, and standards, measures, practices, and procedures within which individual systems are introduced and maintained, including both physical measures and logical and other technical safeguards such as user identifiers, passwords and firewalls.

To the extent they are relevant to the financial statement assertions the auditors consider such matters as:

- the effective use of firewalls and virus protection software
- the effective use of encryption
- controls over the development and implementation of systems
- whether security controls in place continue to be effective for new technologies
- whether the control environment supports the control procedures implemented

2.4.3 Transaction integrity

In particular, controls over transaction integrity will be of great importance, as the system will capture transactions and automatically process them. It is also important that the transaction is processed completely through the accounting system. The website may not be integrated completely with the underlying accounting system.

Hence the assurance services over the design and operation of systems (particularly computerised in this instance) will be of great importance.

The auditors should consider the completeness, accuracy, timeliness and authorisation of information provided for recording and processing in the entity's financial record. Therefore, auditors should carry audit procedures regarding the integrity of information in the accounting system relating to e-commerce transactions that are largely concerned with evaluating the reliability of the systems in use for capturing and processing such information, that is, focusing on automated controls that relate to the integrity of transactions as they are captured and then immediately and automatically processed.
2.4.4 Process alignment

Process alignment refers to the way various IT systems are integrated with one another and therefore operate, in effect, as one system. An entity's website may be inter-related with the accounting system, customer relationship management systems and inventory management systems (often known as 'back office' systems).

When it is relevant to the financial statement assertions, the auditors consider the controls governing the integration of e-commerce transactions with internal systems, and the controls over systems changes and data conversion to automate process alignment.

2.4.5 Lack of trust

A key problem with e-commerce is one of trust. In most cultures, consumers grant their trust to business parties that have a close physical presence: buildings, facilities and people to talk to. On the Internet these familiar elements are simply not there. The seller's reputation, the size of his business, and the level of customisation in product and service also engender trust.

Internet merchants need to elicit consumer trust when the level of perceived risk in a transaction is high. However, research has found that once consumers have built up trust in an Internet merchant such concerns are reduced.

Internet merchants need to address issues such as fear of invasion of privacy and abuse of customer information (about their credit cards, for example) because they stop people even considering the Internet as a shopping medium.

The parties involved in e-commerce need to have confidence that any communication sent gets to its target destination unchanged, and without being read by anyone else.

2.5 Web assurance

It has been a feature of electronic commerce that people seem to be happy to browse online, but less happy to make purchases, due to a lack of knowledge about the company they were dealing with. This led to concerns about

- processing of the transaction
- use of the personal information that must be given to complete the sale; and
- poor business practices by the company (late delivery/errors in orders etc)

Web assurance seeks to remove this barrier by providing assurance to the users of the service. An example of an assurance service developed in relation to e-commerce is WebTrust.

An assurance assignment under WebTrust would involve looking at the assertions of the company relating to the concerns above, and seeking evidence as to whether what they say about their service is true, and whether their systems comply with pre-determined criteria.

The outcome of the exercise is that if the accountant has assurance that the systems comply and the representations made about the service is fair, the website can be WebTrust accredited.

2.6 Providing assurance on the design and operation of the system

The professional accountant should establish whether the engagement relates to a period or a point of time. Normally the professional accountant will involve significant discussions with management to discuss:

- the prevention and detection controls
- the costs and benefits of such controls
- the importance of specific control objectives
- the applicable risks
Internal control systems have inherent limitations and therefore any assurance report on internal controls systems should mention these inherent limitation to minimise the unnecessary expectation gap.

### 2.7 Computer systems

In today’s world, most entities use computer systems to run their businesses and the accounting and financial information is processed and stored on a computer system.

Computer controls can be classified into:
- security controls
- integrity control
- contingency controls

Integrity controls can be divided into:
- **data integrity** is preserved when data is the same as it is in source documents and has not been accidentally or intentionally destroyed, modified or disclosed
- **systems integrity** refers to system operation conforming to the design specification despite attempts to make it behave incorrectly

Auditors should focus on the general and application controls of the system when assessing and testing controls for the purposes of the statutory audit.

Risks that often occur within the control systems are when the system is interrupted by virus and the whole system will spread and the computer system will breakdown. Another risk is when an unauthorised user has logged into the system.

Therefore, the client should have contingent plans in the event when the system is being affected by the risks. The entity might seek assurances from its service provider.

### 2.8 System audits

The auditors should assess the quality and effectiveness of the accounting system and the report should be outside the scope of the audit and should be on specific findings. Some of the areas an auditor would focus are:

- **Management policy**
  - Any written statement of policy with regard to computer systems?
  - Is it compatible with management policy?
  - Is it effective and sufficient?
  - Is it updated when the systems are updated?
  - Is it related to current system?

- **Segregation of duties**
  - Is there adequate segregation of duties?
  - Are there adequate controls to enforce segregation of duties?

- **Security**
  - Are the physical security, access security and data security in place?
  - Is it sufficient and effective?

### 2.9 Audit considerations on e-commerce business

Auditors must assess their clients’ procedures for identifying and addressing those risks relating to e-commerce activities. Some main considerations are:

- Has management established an information and Internet security policy?
How does the entity identify critical information assets and the risk to these assets?

Does the entity have cyber insurance (many general policies now exclude cyber events)?

Is there a process for assuring security when linked to third party systems (eg partners/contractors)?

What controls are in place to ensure that employees only have access to files and applications that are required for their job?

Are regular scans carried out to identify malicious activity?

Are procedures in place to ensure that security is not compromised when the company’s systems are accessed from home or on the road?

What plans are in place for disaster recovery in case of an incident?

These issues will be built into the auditor’s assessment of the control environment of the entity and in some cases may influence the auditor’s view as to whether there are any uncertainties relating to the going concern status of the entity.

The auditors consider whether the entity’s security of information policies, and security controls as implemented, are adequate to prevent unauthorised changes to the accounting system or records, or to systems that provide data to the accounting system.

The auditors may test automated controls, such as record integrity checks, electronic date stamps, digital signatures, and version controls when considering the integrity of electronic evidence.

Self-test question 1

World Expert Co (World Expert) is a travel agency operating in three adjacent towns. The directors have recently taken the decision that they should cease their operations and convert into a dot.com. The new operation, Worldexpert.com, will benefit from enlarged markets and reduced overheads, as they will be able to operate from single, cheaper premises.

Such a business decision has opened World Expert up to significant new business risks, so what are the risks and the impact on auditor’s risk assessment?

(The answer is at the end of the chapter)

2.10 Controls in computerised processing

It is possible to build controls into computerised processing. A balance must be struck between the degree of control and the requirement for a user friendly system.

When auditors undertake their assessment and testing of controls for the purposes of the statutory audit, they focus on the general and application controls of the system, which relate to security and policies for data input, processing and output.

In other words, when undertaking the work for the statutory audit, the auditor is interested in the data integrity, as it is the data which is incorporated into the financial statements.

However, it is also important to stakeholders in the entity that the system used, which will often impact on operation as well as financial information, operates reliably and that risks are mitigated.

The two key risks are:

- the system being put at risk by a virus or some other fault or breakdown which spreads across the system; and
- the system being invaded by an unauthorised user who could then
  - affect the smooth operation of the system; or
  - obtain commercial sensitive information
The client is likely to have contingency plans in the event of the system being affected by the risks outlined above. However, it is also important to know that the original system is as reliable as could be expected, and whether it is the best system that the entity could be using, at the given cost.

The company might seek such assurances from its service provider. However, the service provider has a vested interest in the company believing that its system is reliable and the best available, because he is paid to supply it.

This means that the directors might seek an assurance service from its auditors or another firm of accountants, to undertake work to ascertain if the assertions of the service provider are correct.

If a firm of accountants were to consider taking on such an assurance engagement, they should ensure that they had sufficient skill to undertake the procedures required to ascertain if the assurances were correct. They would have to ensure that they had an IT specialist on the team.

Internal control effectiveness is generally assessed by means of undertaking a systems audit.

2.11 System reporting

It is vital that management receive information on the effectiveness of their controls systems and systems reliability generally. This is because, as stated earlier, the operations of the entity are likely to rely heavily if not completely on computer systems, and if problems arise, operations could be severely affected.

Problems could arise in terms of:
- no production being possible
- no invoicing being possible; or
- invoicing being duplicated or omitted

Other stakeholders, such as customers and suppliers, will also be interested in the reliability of the company's systems, as they will not want to deal with an entity who makes mistakes and cannot operate properly.

It is because of the vital importance of this area to business that management may also want to obtain assurance concerning the information it receives on systems reliability.

3 Computer-assisted audit techniques (CAATs)

CAATs involve the use of computers for audit work but do not alter the overall scope or objective of the audit. They are particularly useful where the is no paper audit trail or in testing large samples of data. The two most commonly used CAATs are audit software and test data.

Practice Note 1009 Computer-assisted Audit Techniques (CAATs) (PN 1009) provides guidance on the use of computer-assisted audit techniques (CAATs). Its application is to all users of CAATs involving a computer of any type or size.

Key term

Computer-assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool.

There is no change to the overall objectives and scope of an audit when it is conducted in a computerised environment. The Practice Note states: “However, the application of auditing procedures may require auditors to consider techniques that use the computer as an audit tool.
These uses of the computer for audit work are known as computer-assisted audit techniques (CAATs).”

CAATs are useful when performing a range of auditing procedures, such as the following:

- **Tests of details** of balances and transactions
- **Analytical review procedures**
- **Tests of computer information system controls**
- **Sampling** programs to extract data for audit testing
- **Reperforming** calculations performed by the entity’s accounting systems

The use of CAATs has grown as they have been shown to have a wide range of useful applications:

(a) Auditors can test program controls as well as the general internal controls associated with computers to obtain evidence of the existence and operation of those controls

(b) Larger sample sizes can be tested within time and resource constraints than would otherwise be possible

(c) Auditors can test transactions rather than the paper records of transactions which may be incorrect or missing

(d) CAATs are cost-effective in the long-term if the client does not change its systems involving modification to custom software or new software purchases

(e) Results from CAATs can be compared with results from traditional testing – if the results correlate, overall confidence is increased

The major steps to be undertaken by the auditors in the application of a CAAT are as follows:

(a) **Set the objective** of the CAAT application.
(b) **Determine** the content and accessibility of the entity’s files.
(c) **Define** the transaction types to be tested.
(d) **Define** the procedures to be performed on the data.
(e) **Define** the output requirements.
(f) **Identify** the audit and computer personnel who may participate in the design and application of the CAAT.
(g) **Refine** the estimates of costs and benefits.
(h) **Ensure** that the use of the CAAT is properly controlled and documented.
(i) **Arrange** the administrative activities, including the necessary skills and computer facilities.
(j) **Execute** the CAAT application.
(k) **Evaluate** the results.

### 3.1 Audit software

**Key term**

**Audit software** is used by auditors to interrogate an entity’s data and files. It may be generic audit software or custom audit software and will be used to carry out substantive procedures.
3.1.1 Types of software

**Generalised audit software (package programs)** allows auditors to:

(a) perform tests on an entity’s computer files and databases, such as reading and extracting data from a client’s systems for further testing

(b) select data that meets certain criteria in order to create populations and samples

(c) perform calculations on data, facilitating audit sampling and producing documents and reports

By automating these processes the auditors are able to devote more resources to analysing and investigating the results and so increase their chance of detection of material misstatement.

**Custom audit software (purpose-written programs)** is written by auditors for specific tasks when generic audit software is unsuitable for the purpose. This may be based on the client’s own software, modified as necessary, as this is more cost effective than creating new software from first principles. **Utility programs** are used by an entity to perform common data processing functions, such as sorting, creating and printing files.

**System management programs** are enhanced productivity tools that are typically part of a sophisticated operating systems environment, for example, data retrieval software or code comparison software.

The table below gives a range of examples of the use of audit software:

<table>
<thead>
<tr>
<th>Audit software: applications</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Perform calculations and comparisons in analytical procedures</td>
</tr>
<tr>
<td>• Sampling programs used to extract data for audit testing, eg select a sample of receivables for confirmation</td>
</tr>
<tr>
<td>• Scan a file to ensure that all documents in a series have been accounted for or to search for large and unusual items</td>
</tr>
<tr>
<td>• Compare data elements in different files for agreement (eg prices on sales invoices to authorised prices in master file)</td>
</tr>
<tr>
<td>• Reperform calculations eg casting sales ledger</td>
</tr>
<tr>
<td>• Prepare documents and reports eg produce receivables confirmation letters and monthly statements</td>
</tr>
<tr>
<td>• Interrogation software, which accesses the client’s data files</td>
</tr>
<tr>
<td>• Comparison programs, which compare versions of a program</td>
</tr>
<tr>
<td>• Interactive software for interrogation of online systems</td>
</tr>
<tr>
<td>• Resident code software to review transactions as they are processed</td>
</tr>
</tbody>
</table>

Audit interrogation software is particularly appropriate during substantive testing of balances and transactions. By automating procedures the auditors are able to **scrutinise large volumes of data** and **concentrate skilled manual resources on the investigation results**, rather than on the extraction of information and selection of samples.
3.2 Test data

Key term

Test data techniques are used for tests of controls. By inputting a sample of transactions or other relevant data into an entity’s computer system, and comparing the results obtained with predetermined results, an auditor is able to check that the entity’s systems are processing data in the correct way.

One way of checking whether a system is processing data correctly is to enter some valid test data and compare the results against what is expected to happen. Test data may also be used to establish whether the controls that prevent the processing of invalid data are working effectively. Invalid data might include, for example:

- A non-existent customer code
- A transaction worth an unreasonable amount,
- A transaction which if processed would be in breach of authorisation limits such as customer credit limits.

There are three different ways to apply test data techniques:

(a) Test data may be used to test specific controls in computer programs, such as online passwords and data access controls.

(b) Test transactions may be selected from transactions already processed or created by the auditors to test specific processing characteristics of an entity’s computer system. These transactions are usually processed separately from the entity’s routine processing. This might include the testing of the processing of invalid data as discussed above.

(c) Test transactions may be used in an integrated test facility. This is where a ‘dummy’ unit (perhaps a department or employee) is created, and to test transactions are input during the normal processing cycle.

One significant problem with test data is that it may cause an inadvertent corruption of data files which has to rectified. This may be difficult with modern real-time systems, which often have in-built (and much to be encouraged) controls to ensure that data once entered cannot be easily removed without leaving a trace.

Another problem with test data is that it only tests the operation of the system at one point in time. Also, auditors are testing only the controls in the programs being operated and which they know about.

These significant drawbacks has reduced the use of test data as a CAAT.

3.2.1 Procedures to control test data applications

It is important to have audit procedures in place to control test data applications. These may include the following:

(a) Controlling the sequence of submissions of test data where it spans several processing cycles

(b) Performing test runs containing small amounts of test data before submitting the main audit test data

(c) Predicting the results of the test data and comparing it with the actual test data output, for the individual transactions and in total

(d) Confirming that the current version of the programs was used to process the test data

(e) Testing whether the programs used to process the test data were the programs the entity used throughout the applicable audit period.
3.2.2 Embedded audit facilities

The results of using test data rely on the fact that the programs used to process it are the ones in general use for processing. If a member of the IT department commits fraud by substituting one version of the program that gives the correct results, purely for the duration of the test, and then replaces it with a version that siphoned off the entity's funds into his own bank account, the effect of test data is totally negated.

*Embedded audit facilities* prevent this type of fraudulent activity. An embedded facility consists of audit modules that are incorporated into the computer element of the entity's accounting system which allow a continuous review of the data recorded and the manner in which it is treated by the system.

The use of IT to produce reports adds complexity to the work of auditors. They need to ensure that:

(a) there is excellent version control over the reports produced: ie no-one relies a report that has been superseded

(b) the reports are protected from interference (sometimes called hacking)

(c) the auditors involved have sufficient IT expertise as they need to understand the systems, and how they work, as well as the overall objectives they are trying to achieve

3.3 Considerations in the use of CAATs

How much and for what an auditor will rely on CAATs as part of an audit will form part of the overall audit plan. Included in the auditor’s considerations will be the following factors:

- The IT knowledge, expertise and experience of the audit team
- The availability of CAATs and suitable computer facilities and data
- The impracticability of manual tests
- Effectiveness and efficiency
- Time availability

The entity’s systems and controls and how effective CAATs will be in meeting the audit objectives.

3.4 Controlling the CAAT application

3.4.1 Control procedures for the use of CAATs

The specific procedures used to control the use of a CAAT depend on the intended application. In establishing controls, the auditors shall consider the following:

- approve specifications and conduct a review of the work to be performed by the CAAT
- review the entity's general controls that may contribute to the integrity of the CAAT
- ensure appropriate integration of the output by the auditors into the audit process.

When the auditors intend to perform audit procedures at the same time as online processing, the auditors shall discuss the processes with the entity’s management and must obtain management’s approval before conducting the tests in order to maintain security over and data integrity of client records.

<table>
<thead>
<tr>
<th>Procedures carried out by auditors to control CAAT applications</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Designing and testing the CAAT.</td>
</tr>
<tr>
<td>• Where applicable, checking the coding of the program to ensure that it conforms with the detailed program specifications.</td>
</tr>
<tr>
<td>• Liaising with the entity's IT department to ensure that the software will run on the entity's computer systems.</td>
</tr>
</tbody>
</table>
• Running the audit software on small test files first before running it on the main data files.
• Checking whether the correct files were used, for example, by checking external evidence, such as control totals maintained by the user, and that those files were complete.
• Obtaining evidence that the audit software functioned as intended, for example, by reviewing output and control information.
• Establishing appropriate security measures to safeguard the integrity and confidentiality of the data.

3.4.2 Control procedures for the use of audit-enabling software
Audit procedures to control the use of audit-enabling software may include the following:
(a) Verifying the completeness, accuracy and availability of the relevant data, for example, historical data may be required to build a financial model
(b) Reviewing the reasonableness of assumptions used in the application of the tool set, particularly when using modelling software
(c) Verifying availability of human resources skilled in the use and control of the selected tools
(d) Confirming the appropriateness of the tool set to the audit objective, for example, the use of industry specific systems may be necessary for the design of audit programs for unique business cycles

3.5 Documentation
The standard of working paper documentation and retention procedures for a CAAT should be consistent with that for the audit as a whole.

3.6 Using CAATs in small entity IT environments
Small entities may create a particular set of difficulties in the use of CAATs. It is for the auditors to determine at the planning stage whether the use of CAATs will be effective in a small or medium-sized entity.
(a) The level of general controls may be less in a small entity so the auditors place less reliance on the system of internal control. As a result there will be more emphasis on tests of details of transactions and balances and analytical review procedures. This may make CAATs, particularly the use of audit software, particularly useful.
(b) For smaller volumes of data, manual methods for testing may be more cost effective.
(c) Auditors should bear in mind that a small entity may not have adequate technical support in-house, making the use of CAATs impracticable.
(d) Certain audit package programs may not operate on small stand-alone computers, thereby restricting the auditors’ choice of CAATs. Sometimes, the entity's data files may, be copied and processed on an alternative computer with obvious controls being necessary over the confidentiality and security of files.
Self-test question 2

One of your clients, ABC Ltd, uses an Online Integrated Management Information System (OIMIS) for managing its inventory and financial reporting purpose. Explain what test of controls on inventory can be performed by using CAATS. In addition, explain what tests would need to be performed prior to placing reliance on management data?

(The answer is at the end of the chapter)

4 Stand-alone computers

Topic highlights

Under stand-alone computer environments, the user tends to process many accounting application programs and normally the user will purchase off-the-shelf software packages. PC environment is less structured than a centrally controlled IT environment, therefore users may not regard controls as important and cost effective.

Practice Note 1001 (PN 1001) describes the effects of stand-alone PCs on the accounting system and related internal controls and on audit procedures.

4.1 Characteristics for entities that use stand-alone PCs

It is most common for small entities where the personal computer (PC) constitutes the entire computer-based accounting system. Stand-alone PCs can be operated by a single user or many users at different times accessing the same different programs on the same computer.

Under stand-alone computer environments, the user tends to process many accounting application programs and normally the user will purchase off-the-shelf software packages. The PC environment is less structured than a centrally controlled IT environment, therefore users may not regard controls as important and cost effective.

In contrast, the effectiveness of controls relating to a stand-alone PC used within a larger entity may depend on an organisational structure that clearly segregates responsibilities and restricts the use of the stand-alone PC to specific functions. When a PC is linked to other computers in a network, the risks would increase.

In a typical stand-alone PC environment, the level of general controls is lower than expected in a large-scale entity.

4.2 Internal controls in a stand-alone PC environment

As mentioned above, normally the controls that are used for large computer systems would not appear for PCs. In contrast, certain types of internal controls become more important because of the characteristics of stand-alone PCs and the environments in which they are used.

The organisational structure within which a stand-alone PC is used is important in assessing risks and the extent of the controls required to mitigate those risks.

Ordinarily, PCs users have only basic data processing skills and implement application programs relatively quickly, triggering issues such as the adequacy of systems' documentation or access control procedures.

Such users may not regard controls over the application implementation process (for example, adequate documentation) and operations (for example, access control procedures) as important or
cost-effective. In such circumstances, because the financial information is processed on a computer, users may tend to place unwarranted reliance on it.

Effective policies and procedures for the acquisition, implementation, operation and maintenance of stand-alone PCs can enhance the overall control environment. A failure to implement such policies may lead to the entity using out of date programs and to errors in the data and the information derived from them, and may lead to an increased risk of fraud.

When PCs are accessible to many users, there is a risk that the operating system, programs and data may be altered without authorisation, or that users may install their own versions of programs giving rise to potential software licensing liabilities.

The following are some of the typical internal controls in a stand-alone PC environment:

(a) **Set up organisational policies and procedures** – on acquisition, implementation, operation and maintenance can enhance the overall control environment, ie passwords management, training, personal policies, software acquisition, data protection standards and virus protection

(b) **Physical protection for equipment** – locked rooms, alarm system, encryption of key files and other access controls

(c) **Physical protection for removable and non-removable media** – ie USB, CDs, external hard disks, remove media off-site

(d) **Program and data security** – using passwords, implementing access control package, removable storage media, using encryption and using hidden directories and files

(e) **Continuity of operations** – retain copies of the operating systems, programs and data in a secure location

### 4.3 Auditing in a stand-alone PC environment

In a stand-alone PC environment, the client may not implement sufficient controls to reduce the risks of undetected errors since it is not practicable nor cost effective to do so. The auditor should find it more cost effective to concentrate audit work by using substantive procedures rather than analysing the general controls and application controls in details. Auditors may use more extensive physical examination and confirmation of assets, more tests of transactions, larger sample sizes and greater use of computer-assisted audit techniques (CAATs).

If the level of general controls appears adequate, the auditors may consider adopting a different approach ie combined approach.

### 5 Online computer systems

**Topic highlights**

Auditors will test general controls and application controls such as testing transactions logged by the online system for authorisation, completeness and accuracy, in a well-designed and controlled online computer system.

Practice Note 1002 (PN 1002) describes the effects of an online computer system on the accounting system and related internal controls and on audit procedures.
5.1 Characteristics for businesses using online computer systems

Online computer systems are computer systems that enable users to access data and programs directly through terminal devices and therefore, it may be complex in technology. The online system may tend to link up with company’s strategies. There would be a higher chance for sharing system resources and many users use the system at the same time.

Online systems allow users to directly initiate various functions such as entering transactions, making inquiries, requesting reports, updating master-files and performing electronic commerce activities.

The most significant characteristics follow:

(a) Online data entry and immediate validation checks
(b) Online access to the system by users enabling them to perform various functions ie to read, to enter or delete transactions; unlimited access to all the functions is not desirable as it will show a lack of segregation of duties and allows users access to all stages of processing and recording a transaction
(c) Possible lack of visible transaction trail – not to provide supporting documents for all transactions entered into the system
(d) Potential access to the system by non-users – including programmers and other third parties. Programmers may have online access to the system that enables them to develop new programs and modify existing programs without proper authorisation

5.1.1 Types of terminal devices:

Online computer systems use many different types of terminal devices such as:

(a) general purpose terminals – keyboard and screen without any validation within the terminal
(b) intelligent terminal basic keyboard and screen with the additional functions of validating data within the terminal, maintaining transaction logs and performing other local processing
(c) PCs – used for all of the functions of an intelligent terminal with additional local processing and storage capabilities
(d) special purpose terminals – point-of-sale devices, automated teller machines, hand-held wireless devices, voice response systems

Online computer systems allow increased sharing of system resources through LANs and WANs. Many different parties can access to an organisation's online applications by using the Internet or other remote access services. Programmers may use the online capabilities to develop new programs and maintain existing programs.

5.1.2 Types of online computer systems

Online computer systems may be classified according to how information is entered into the system, how it is processed and when the results are available to the user. For purposes of this PN, online computer systems functions are classified as follows:

(a) Online/real-time processing – individual transactions are entered at terminal devices, validated and used to update related computer files immediately
(b) Online/batch processing – individual transactions are entered at a terminal device, subjected to certain validation checks and added to a transaction file that contains other transactions entered during the period
(c) Online/memo update (and subsequent processing) – combines online/real time processing and online/batch processing
(d) Online/inquiry – restricts users at terminal devices to making inquiries of master-files
Online downloading/uploading processing — transfer of data from a master-file to an intelligent terminal device for further processing by the user

5.2 Internal controls in an online computer system

Applications in an online environment may have greater exposure to unauthorised access and update. The entity may need to establish suitable general controls to mitigate the risks of viruses, unauthorised access and the potential destruction of audit trails. Hence, access controls are particularly important to online processing.

The following are some of the typical internal controls in an online computer system:

**General controls** such as:
- use of password or online monitors
- physical controls ie locked rooms, inactivity timeouts
- controls over password – independent assignment and maintenance of passwords
- system development and maintenance controls
- programming controls
- transaction logs
- firewalls

**Application controls** such as:
- pre-processing authorisation
- terminal device edit, reasonableness and other validation tests
- input error reporting and handling
- cut-off procedures
- file controls
- master file controls
- balancing

5.2.1 Increase or decrease risk of errors in an online system

The following table illustrates the factors that may increase or reduce the risk of errors occurring within an online systems:

<table>
<thead>
<tr>
<th>Increase risk</th>
<th>Decrease risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Locating terminal devices throughout the entity</td>
<td>Performing data entry at or near the point where transactions originate reduces the risk that the transactions will not be recorded</td>
</tr>
<tr>
<td>Use of online terminal devices — can modify previously entered transactions, computer programs and can access to data and programs from remote locations</td>
<td>Immediate correction and re-entering of invalid transactions</td>
</tr>
<tr>
<td>Online processing interrupted may cause loss of data</td>
<td>Data entry performed by individuals who understand the nature of the transactions</td>
</tr>
<tr>
<td>Online access to data and programs — greater opportunity for access to data and programs by unauthorised persons</td>
<td>Processing transactions immediately</td>
</tr>
<tr>
<td>The use of electronic commerce and EDI for the exchange of documents — loss of audit trail</td>
<td>Authentication and authorisation carried out at or near the point where transactions originate</td>
</tr>
</tbody>
</table>
5.3 Auditing an online computer system

Generally auditors will test general controls and application controls such as testing transactions logged by the online system for authorisation, completeness and accuracy, in a well-designed and controlled online computer system.

If those controls are deemed to be up to standard, the auditors will place reliance on internal controls. Sometimes it may be more effective to perform pre-implementation review of a new online accounting applications rather than to review applications after installation.

Auditors may examine the change management procedures rather than perform pre-implementation reviews for new online accounting applications. Auditors should plan the audit by participating in the online computer controls and should identify the new remote access facilities. Auditors should set preliminary determination, during the risk assessment process, of the impact of the system on the audit procedures ie test of firewalls, test of authorisation and access controls. Auditors can use CAATs and perform the technique of audit software or by entering test transactions through the online terminal devices.

Auditors should consider the need for audit teams with technical skills in online computer systems and the effect of the online computer system on the timing of audit procedures. Auditors should consider the timing of audit procedures ie concurrently with online processing or after processing has taken place.

Self-test question 3

Super Chain Store is a traditional supermarket established 15 years ago by Martin Fok who recently passed the business to his elder son Jack Fok. Jack has just graduated from University and has decided to launch an online ordering and delivery service. Customers can order their wanted items on Super Chain’s website and by debiting credit card first, delivery would be done within three days of payment.

Required

As the auditor for Super Chain since incorporation, you have always performed tests of controls on changes of the system and substantive testing. Determine what audit approach you would adopt when the online service is launched and describe the risks that are associated with this new method of business.

(The answer is at the end of the chapter)

6 Database systems

Topic highlights

Database systems are distinguished by two important characteristics: data sharing and data independence. The software that creates, maintains and operates the database is referred to as a database management system (DBMS).

Practice Note 1003 Database systems (PN 1003) describes the effects of a database system on the accounting system and related internal controls and on audit procedures. It applies to database systems used in multiple user environments.
6.1 Characteristics of database systems

A database is a collection of data that is shared and used by many different users for different purposes. Individual users are aware only of the data that they use and may view the data as computer files utilised by their applications.

Auditors may need special IT skills or may employ IT experts since when an entity uses a database system, the technology is likely to be complex and may be linked with the entity's strategic business plans.

6.1.1 Components of database systems

Database systems consist principally of two components: the database and the database management system (DBMS).

(a) The database

Database systems are distinguished by two important characteristics: data sharing and data independence. These characteristics ordinarily require the use of a data dictionary and the establishment of a data resource management.

(i) Data sharing – permits many users to use the data in different application programs

(ii) Data independence from application programs – single file of data is used by many applications. The independence of the data depends on whether the person can make changes to the application program or the database

(iii) Data dictionary – serves as a tool to maintain standardised documentation and definitions of the database environment and application systems

(iv) Data resource management – ensure data integrity and compatibility and includes a data administration function

(v) Data administration – manages the database ie by responsible for the development, the co-ordination, establishing data standards, training

(vi) Database administration – responsible for structure, security, operational control and efficiency of databases

(b) DBMS

The software that creates, maintains and operates the database is referred to as DBMS. Together with the operating system, the DBMS facilitates the physical storage of the data, maintains the interrelationships between the data, and makes the data available to application programs. It also provides controlled access methods to establish basic security measures over the data. Usually, the DBMS software is supplied by a commercial vendor but will need to be adapted to the entity's needs.

6.2 Internal controls in a database environment

Topic highlights

When determining the extent of reliance on internal controls related to the use of databases in the accounting system, the auditors may consider how the controls are used.

The auditors should consider the security infrastructure before examining the general and application controls. Generally effective controls over the database, the DBMS and the application are the key internal controls. Normally general controls play a more significant role than application controls due to data sharing and data independence. General controls over the database, the DBMS and the activities of the data resource management (data administration and database administration) have a pervasive effect on application processing.
General controls tend to be based on the following models:

(a) **Standard approach for development and maintenance of application programs** – ie formal steps for developing and modifying an application program

Since many users share the data maintained by the client, using a standard approach to develop each new application program and to modify existing application programs would enhance control.

(b) **Data model and data ownership** – a designated person should be responsible for defining access and security rules.

Since many individuals may use programs to input and modify data, the client needs to ensure there is a clear and definite assignment of responsibility for the accuracy and integrity of each item of data.

(c) **Access control** to the database ie passwords. These restrictions should apply to individuals, terminal devices as well as programs

The client should implement adequate procedures for periodic changing passwords, maintaining the secrecy of passwords, and reviewing and investigating attempted security violations.

Relating passwords to defined terminal devices, programs and data helps to ensure that only authorised users and programs can access, amend or delete data.

(d) **Segregation of duties** – Separate design, implement and operate the database

Dividing these responsibilities among technical, design, administrative and user personnel is necessary to ensure the completeness, integrity and accuracy of the database;

(e) **Data security and database recovery** – tends to use general controls

Risk of data corruption is particularly high when database is used by many people inside and outside the company.

### 6.3 The effect of databases on the accounting system and related internal controls

Database systems typically provide the opportunity for greater reliability of data than non-database systems. Since general controls are more important, therefore, this can result in reduced risk of fraud or error in accounting systems where databases are used.

#### 6.3.1 Use of a database under adequate controls

The following improvements can be achieved:

(a) Improved consistency of data is achieved because data are recorded and updated only once, rather than being stored in several files and updated at different times and by different programs.

(b) Integrity of data will be improved by effective use of facilities included in the DBMS, such as recovery/restart routines, generic edit and validation routines, and security and control features.

(c) Other functions available with the DBMS can facilitate control and audit procedures. These functions include report generators, which may be used to create balancing reports, and query languages, which may be used to identify inconsistencies in the data.

#### 6.3.2 Use of a database under inadequate controls

In a typical non-database environment, controls exercised by individual users may compensate for weaknesses in general controls. In a database system, however, individual users cannot always compensate for inadequate database administration controls.
6.4 Auditing a database system

When auditing an entity that operates a database, it is necessary to obtain an understanding of the database control environment and the flow of transactions to assess the audit risk in planning the audit.

The following factors should be considered:

6.4.1 Obtaining understanding

- The relevant access controls
- The DBMS and the significant accounting applications using the database
- The standards and procedures for development and maintenance of application programs using the database
- The data resource management function
- Job descriptions, standards and procedures for those individuals responsible for technical support, design, administration and operation of the database
- The procedures used to ensure the integrity, security and completeness of the financial information contained in the database
- The availability of audit facilities within the DBMS
- The procedures used to introduce new versions of the database into operation

6.4.2 Tests of controls

When determining the extent of reliance on internal controls related to the use of databases in the accounting system, the auditors may consider how the controls are used. If the auditors subsequently decide to rely on those controls, the auditors design and perform appropriate tests.

Generally database’s general controls are the most important. Auditors may find it more cost-effective to understand the database’s internal controls. It will be better to perform test of controls especially on the general controls and CAATs should be used. Audit procedures may include using the functions of the DBMS.

6.4.3 Substantive testing

Substantive testing should be used when there are weak controls in the database. A pre-implementation review of accounting applications rather than to review the applications after installation should be used. This pre-implementation review and review of the change management process may provide the auditors with an opportunity to request additional functions, such as built-in audit routines or controls within the application design.

7 Intranets and extranets

7.1 Intranet

Intranet is the generic term for a collection of private computer networks within an entity. An intranet uses network technologies as a tool to facilitate communication between people or
workgroups to improve the data sharing capability and overall knowledge base of an entity’s employees.

7.1.1 How intranets are used in companies

Intranets utilise standard network hardware and software technologies like Ethernet, WiFi, TCP/IP, Web browsers and Web servers. An entity’s intranet typically includes Internet access but is firewalled so that its computers cannot be reached directly from the outside. A simple intranet consists of an internal email system and perhaps a message board service. More sophisticated intranets include websites and databases containing company news, forms, and personnel information. Besides email and groupware applications, an intranet generally incorporates internal websites, documents, and/or databases.

The business value of intranet solutions is generally accepted in larger corporations, but their worth has proven very difficult to quantify in terms of time saved or return on investment.

Starting in the late 1990s, there had been tremendous growth in intranet users throughout the world, including a broad spectrum of small and medium-sized entities. The benefits of intranets to a small entity, even one run from home, do not substantially differ from the benefits reaped by larger entities. In fact, within large entities there often exist multiple smaller, segregated intranets.

Intranet services promise to grow institutional knowledge and increase employee effectiveness. Online news, secure document sharing, and email are just a few examples of intranet applications. Building intranets using common Web technologies can also fit together nicely into an entity’s external marketing and e-commerce strategies.

7.1.2 Conducting an information audit on intranet

An information audit is a systematic process through which an entity can learn about the information it uses, generates, needs, and shares across its divisions and employees. While an information audit helps define the types of information used by the entity, it can be even more revealing of behaviours such as sharing, noticing and generating.

Where an information audit focuses on the explicit accounting and use of an entity information assets, it can also focus on the entity’s expertise and experience in using IT information. Knowledge is difficult to translate into tangible assets.

Some examples of the detailed procedures in an information audit are to:

(a) obtain a general understanding of the firewall technology infrastructure;
(b) determine security strategy of the entity;
(c) determine whether physical and environmental security is adequately controlled;
(d) determine whether preventive measures from the hacker attacks have been taken and implemented on the firewall servers; or
(e) determine whether appropriate user access controls over the firewall servers are in place.

7.2 Extranet

A common extension to intranets, called extranets, opens this firewall to provide controlled access to outsiders.

An extranet is a networking environment set up so that a customer, supplier, consultant and anyone outside the company can access data and/or applications inside the entity’s network but an intranet is still seen primarily as a corporate productivity tool.

Extranet access from the Internet can be controlled through various tools such as password or username specific. In other words, areas of the extranet will be available according to password credentials. This limits users to extranet pages relevant to the business they might be conducting, while keeping other areas of the extranet private and secure.
7.2.1 Risks associated with extranet

Increasingly extranets are being used by entities to conduct e-business operations. However, an extranet must be properly planned, implemented and maintained to ensure that it does not pose an unacceptable risk to an entity’s internal data and information systems.

There are potential risks such as security risks associated with extranets and the companies should pose actions to mitigate against them.

Use of extranets can pose the following risks:

(a) The more people can enter into an entity’s network, the more possibility for the wrong people to get in and do damage to internal systems and data
(b) The risks of computer viruses and other malicious code can attack information and information systems
(c) It allows unauthorised users to exploit sensitive information of the entity
(d) If connecting parties to the extranet have inadequate access controls or have a lack of understanding of extranet security policies and requirements, they could expose the interconnected networks to penetration

Security measures must be identified and implemented to mitigate the risks and these measures must address the changing and evolving security risks of the extranet. It is critical that all parties to an extranet connection understand their systems and the security risks posed by conducting risk assessment and have a common understanding and agreement on what security controls need to be in place to mitigate these risks.

7.2.2 Conducting extranet auditing

To help control risks associated with extranet, parties to the extranet should install auditing mechanisms such as security audits to record activities occurring across the interconnection. Some types of activities to be audited include event type, date and time of event, user identification, the success or failure of access attempts and security actions taken by the system administrators or security personnel.

Entities will continue to use extranets to increase their productivity and efficiency, and to meet customer service requirements. However, using an extranet exposes the entity to increased security risks. To address these risks and minimise the chances for unauthorised access into their information systems, entities can implement a number of security measures. Such measures range from developing a comprehensive extranet security policy and extranet security contract to implementing physical and logical security measures to control user access and ensure network, information system and information security.

8 IT internal audit

Topic highlights

Technology plays an increasing critical role in the daily management of entities. Meanwhile unintentional data loss incidents and IT failures have increased due to both unintentional or intentional acts. In this IT environment, the role and importance of IT internal audit have grown drastically for maintaining the security of commercial data and the reputations of corporate institutions.
8.1 Detailed plan for the IT audit

The IT internal auditor should prepare a detailed plan of the audit and determine the scope of the audit activity as they are essential for ensuring that organisational risks are understood and addressed via the internal audit plan. However, often IT audit is delivered separately from an audit. Many IT audit tools deliver a structured approach to planning and focus the IT audit on the business and technological risks of the entity.

It is suggested that IT internal audit should be integrated into wider audit activity, for example, including Sarbanes-Oxley compliance. This is to ensure the independence and objectivity of IT internal auditors is not compromised by becoming involved in business and systems decision-making.

Recruiting the right staff with the right skills and experience is critical for successful delivery of an effective IT audit plan. This can be achieved by encouraging IT and non-IT auditors to work more closely together in the workplace.

Audit departments need to use automated tools more widely. It is believed that the most technically proficient staff can lead the way in enhancing the efficiency of the IT internal audit process through automation. Readily-available tools are most commonly used by IT internal audit staff.

8.2 Detailed plan: the IT audit

The following are some suggestions to improve effectiveness of IT audit:

(a) IT internal audit should seek to get closer to the business and to IT decision-makers. Professionals must demonstrate that business and technology risks are equally understood. Audit plans should be reviewed on a rolling or quarterly basis to help businesses respond more rapidly to change the risk.

(b) Align IT audit to other governance activities to benefit from scale and expertise.

(c) Encourage IT auditors to engage in other value-adding activities within the business without compromising their independence or the integrity of the audit.

(d) Ensure that audit plans are signed off at audit committee or chief audit executive level and that the head of audit reports to the board of the directors/audit committee.

(e) Integrate IT auditors and non-IT auditors to facilitate cross-learning of technical skills.

(f) Increase training in specialist skill areas such as IT security.

(g) Conduct end-of-engagement assessments to identify opportunities to improve skills and the efficiency of the audit process.

(h) Make better use of automated tools to handle volumes of data to enhance the reliability of audit conclusions.

(i) Make sure executive management reads the report and that comments are incorporated to enhance the perceptions and value of internal audit within the wider entity.

(j) Measure the quality of work undertaken by IT internal audit and implement satisfaction surveys. Communicate the results.
An information technology (IT) audit is a test of controls in a specific area of the business.

The auditor needs to consider whether the skills and Internet business knowledge of team members are appropriate to perform the audit for e-commerce businesses.

The auditor uses knowledge of the entity gained to identify events, transactions and practices related to business risks arising from e-commerce activities that may result in material misstatements in the financial statements.

CAATs are the use of computers for audit work. The two most commonly used CAATs are audit software and test data.

Under stand-alone computer environments, the user tends to process many accounting application programs and normally the user will purchase off-the-shelf software packages. PC environment is less structured than a centrally controlled IT environment, therefore users may not regard controls are important and cost effective.

Auditors will test general controls and application controls such as testing transactions logged by the online system for authorisation, completeness and accuracy, in a well-designed and controlled online computer system.

Database systems are distinguished by two important characteristics: data sharing and data independence. The software that creates, maintains and operates the database is referred to as DBMS.

When determining the extent of reliance on internal controls related to the use of databases in the accounting system, the auditors may consider how the controls are used.

Intranets and extranets are communication tools designed to enable easy information sharing within workgroups.

IT internal auditor should detailed plan the audit and determine the scope of the audit activity as they are essential for ensuring that organisational risks are understood and addressed via the internal audit plan. However, often IT audit is delivered separately from an audit.
**Answers to self-test questions**

**Answer 1**

**Customers**

Converting to a dot.com company in this way enforces a loss of 'personal touch' with customers. World Expert’s staff will no longer meet the customers face to face. In a business such as a travel agency, this could be a significant factor. Customers may have appreciated the service given in branches and may feel that this level of service has been lost if it is now redirected through computers and telephones. Trippers should be aware of the possibility of, and mitigate against, loss of customers due to perceived reduction in service.

**Competition**

By leaving the local area and entering a wider market, World Expert is opening itself up to much more substantial competition. Whereas previously, World Expert competed with other local travel agents, it will now be competing theoretically with travel agents everywhere that have Internet facilities.

**Technology issues**

As World Expert has moved into a market that necessitates high technological capabilities, a number of business risks are raised in relation to technological issues:

**Viruses**

There is a threat of business being severely interrupted by computer viruses, particularly if the staff of World Expert are not very computer literate or the system the company invests in is not up to the standard required.

Viruses could cause interrupted sales and loss of customer goodwill, which could have a significant impact on the going concern status of the company.

**Loss of existing custom**

Technology could be another reason for loss of existing customers. Their existing customers might not have Internet access or ability to use computers. We do not know what World Expert's demographic was prior to conversion.

However, if conversion means that World Expert lose their existing client base completely and have to rebuild sales, the potential cost in advertising could be excessive.

**Cost of system upgrades**

Technology is a fast moving area and it will be vital that World Expert's website is kept up to current standards. The cost of upgrade, both in terms of money and business interruption, could be substantial.

**New supply chain factors**

World Expert may keep existing links with holiday companies and operators. However, they will have new suppliers, such as Internet Service Providers to contend with.

**Personnel**

Due to the conversion, Worldexpert.com will require technical staff and experts. They may not currently have these staff. If this is the case, they could be at risk of severe business interruption and customer dissatisfaction.

If the directors are not computer literate, they may find that they are relying on staff who are far more expert than they are to ensure that their business runs efficiently.
Legislation
There are a number of issues to consider here. The first is data protection and the necessity to comply with the law when personal details are given over the computer. It is important that the website is secure.

E-commerce is also likely to be an area where there is fast moving legislation as the law seeks to keep up with developments. World Expert must also keep up with developments in the law.

Last, trading over the Internet may create complications as to what domain World Expert are trading in for the purposes of law and tax.

Fraud exposure
The company may find that it is increasingly exposed to fraud in the following ways:

- Credit card fraud relating from transactions not being face to face
- Hacking and fraud relating from the website not being secure
- Over-reliance on computer expert personnel could lead to those people committing fraud

World Expert's auditors will be regarding the conversion with interest. The conversion will also severely affect audit risk.

Impact on audit risk
Inherent risk
Many of the business risks identified above could have significant impacts on going concern.

Control risk
The new operations will require new systems, many of which may be specialised computer systems.

Detection risk
The conversion may have the following effects:

- Create a 'paperless office' as all transactions are carried out online – this may make use of CAATs essential
- The auditors may have no experience in e-commerce which may increase detection risk
- There are likely to be significant impacts on analytical review as results under the new operations are unlikely to be very comparable to the old
- There may be a significant need to use the work of experts to obtain sufficient, appropriate audit evidence

Answer 2
Tests of controls on inventory using CAATS
When performing key tests of controls in a CIS environment, auditors should use CAATS to:

- ensure suppliers used are selected from the list of approved suppliers maintained on the master file
- ensure codes scanned on goods received match those on the master file
- identify slow moving inventories by file interrogation
- ensure password access is functioning as expected and staffs only have access to the functions they need
- ensure additions and extensions to inventory listing matches with the general ledger
- show listing of inventories showing ageing and turnover
Tests that would be performed prior to placing reliance on management data:

- Reconciling balances per CAATs (i.e., management account balances) to balances as per general ledger
- Review total number of transactions or items
- Inspection latest version of the source data files used (e.g., manually tracing a sample of items from the CAAT reports to the latest hard copy data files)
- Reperform a sample of calculations to ensure they are reliable

If CAATS cannot be used, auditors should consider any manual procedures before auditors consider to qualify the report.

**Answer 3**

**Overall audit objective and scope**

The change of mode of business from traditional method to the online status, the overall objective and scope of an audit does not change in an environment where computer information systems are involved in the processing of financial information significant to the audit (a 'CIS' environment).

However, the use of a computer changes the processing, storage and communication of financial information and may affect the accounting and internal control systems employed by the entity. The nature of the risks and the internal control characteristics in CIS environments would therefore be different from a non-CIS environment.

**Inherent and control risks**

The inherent risks and control risks in a CIS environment may have both a pervasive effect and an account-specific effect on the likelihood of material misstatements.

The risks may result from deficiencies in pervasive CIS activities such as program development and maintenance, systems software support, operations, physical CIS security, and control over access to special privilege utility programs. These deficiencies would tend to have a pervasive impact on all application systems that are processed on the computer.

The characteristics of a CIS environment are as follows:

- Lack of transaction trails
- Uniform processing of transactions
- Lack of segregation of functions
- Potential for errors and irregularities
- Initiation or execution of transactions
- Dependence on other controls over computer processing
- Potential for increased management supervision
- Potential for the use of computer-assisted audit techniques ('CAATs').

**Specific audit objective and procedures**

The auditors’ specific audit objectives do not change whether accounting data is processed manually or by computer.

However, the method of applying audit procedures to gather evidence may be influenced by the method of computer processing. During the planning stage, auditors have to consider whether they have the competence, skills and experience to audit in a computerised system. Since there is lack of physical evidence for the system, auditors may consider applying control approach when gathering information. Auditors should perform tests of control when substantive alone can’t provide sufficient and appropriate audit evidence to reduce the automation risk.
Computer controls

23 minutes

(a) On-line real-time computer systems in large multinational corporations tend to have strong controls. Describe some of the typical controls within an online real-time computer system in a large corporation to ensure data and records are properly processed and kept. (5 marks)

(b) Smaller business entities using stand-alone PC systems often have weak general controls. Explain why there are often weaknesses in a stand-alone PC system in a small entity. (4 marks)

(c) Describe the nature of stand-alone PCs, explain the general controls that may operate in a small stand-alone PC environment, and explain how a lack of general controls in such a system may affect the audit. (4 marks)

(Total = 13 marks)

HKICPA February 2006
Answers to exam practice questions
Business Assurance
Chapter 1 Scope of corporate governance

Definition of corporate governance

Corporate governance can be defined broadly as the system by which an organisation is directed and controlled. It is concerned with systems, processes, controls, accountability and decision making at the heart of and at the highest level of an organisation. It is therefore concerned with the way in which top managers execute their responsibilities and authority and how they account for that authority to those who have entrusted them with assets and resources. In particular it is concerned with the potential abuse of power and the need for openness, integrity and accountability in corporate decision making.

Recommendations of corporate governance codes

Clearly, a company must have senior executives. The problem is how to ensure as far as possible that the actions and decisions of the executives will be for the benefit of shareholders. Measures that have been recommended by various corporate governance codes include the following.

Directors

(a) A listed company is required by the ‘voluntary’ UK Corporate Governance Code and Hong Kong Code on Corporate Governance Practices to appoint non-executive directors, most of whom should be independent. The non-executives are intended to provide a check or balance against the power of the chairman and chief executive.

(b) The posts of chairman and chief executive should not be held by the same person, to prevent excessive executive power being held by one individual.

(c) Non-executive directors should make up the membership of the remuneration committee of the board, and should determine the remuneration of executive directors. This is partly to prevent the executives deciding their own pay, and rewarding themselves excessively. Another purpose is to try to devise incentive schemes for executives that will motivate them to achieve results for the company that will also be in the best interests of the shareholders.

Risk assessment

The requirement in many codes for a risk audit should ensure that the board of directors is aware of the risks facing the company, and have systems in place for managing them. In theory, this should provide some protection against risk for the company’s shareholders.

Dialogue with shareholders

Both the UK Corporate Governance Code and the Hong Kong Code on Corporate Governance Practices encourage greater dialogue between a company and its shareholders. Institutional investor organisations are also encouraging greater participation by shareholders, for example in voting.

Audits

The audit committee of the board is seen as having a major role to play, in promoting dialogue between the external auditors and the board. Corporate governance should be improved if the views of the external auditors are given greater consideration.
Chapter 2 Corporate governance reports and practice

Split of role of chairman and chief executive

Governance reports recommend that the roles of chief executive and chairman should be split between different individuals. It seems best for one of the existing NEDs to be appointed as chairman. Splitting the roles emphasises the two jobs are distinct, with the chief executive running the charity and the chairman running the board. The chairman can ensure the chief executive is accountable for his actions, by for example ensuring the board has enough information to exercise oversight of the chief executive. At present the chief executive is able to manipulate the information the board receives, to protect his position.

Appointment of secretary

The board’s functioning would be better if someone acted as company secretary. The secretary could undertake a number of tasks currently undertaken by the CEO including distributing board minutes in advance of meetings and briefing board members in relation to each agenda item. This would free up the time of the CEO or chairman. The secretary should be accountable to the board collectively, and should if necessary have the independence to come into conflict with the CEO if the secretary believes it is in the interest of Care Co.

More executive directors

The UK Higgs report commented that there is a greater risk of distortion or withholding of information, or lack of balance in the management contribution, when there is only one or a very small number of executives on the board. Care Co should consider appointing one or two more executive directors, for example an Operations Director; this would also help with succession planning, and lead to a greater emphasis on risk management and operational control at board level.

Audit committee

Appointing a separate audit committee will enable the main board to concentrate more on strategic and operational matters, leaving the audit committee to undertake the detailed financial review that is a major part of current board meetings. The audit committee should also be responsible for appointment of auditors and liaison with them about further work including review of controls. At present the auditors’ ability to exercise independent scrutiny could be questioned, since they have been appointed by the CEO.

Governance reports recommend that all members of the committee should have sufficient financial expertise to contribute effectively, and that one member should have relevant and recent financial experience. New directors may therefore need to be recruited to fulfil this requirement or existing members receive training.

Nomination committee

A nomination committee of NEDs would oversee the appointment of the new directors that Care Co’s board appears to need. The committee would also review other important issues of board functioning that have not been considered recently, such as:

• The balance between executives and NEDs
• Whether there are gaps between the skills, knowledge and experience possessed by the current board and what the board ideally should have
• The need to attract board members from a variety of backgrounds
• Whether Care Co will need to pay some NEDs to attract the right candidates

Independent NEDs

Governance reports recommend that at least half the board are independent NEDs, without business or financial connections, who face re-election regularly. It is possible that none of the current NEDs can be classed as independent, since they have all been appointed on the basis of previous business.
connections. Independent NEDs will be particularly important for Care Co as it is a charity, and stakeholders will rely on NEDs to provide unbiased scrutiny of how the executive directors are conducting its affairs.

**Expert NEDs**

NEDs with **experience of the charity sector** need to be appointed. The reason given for not discussing operational matters, that these are outside the directors’ experience, indicates that as a body the NEDs have **insufficient expertise** at present. The CEO’s belief that the executive management team is more than capable of managing the delivery of the in-home care services misses the point. NEDs should **scrutinise**, and if necessary **challenge**, the way the CEO is running operations, drawing on their own experience.

**Stakeholder representation**

There appears to be a **lack of stakeholder representation** on the board; with fund providers, volunteer helpers and users of Care Co’s services not being represented. Having a user representative on the board would mean that the board received **direct feedback on the effectiveness of the charity’s activities**. Stakeholder representatives could also provide feedback to the stakeholders they represent on the reasoning behind board decisions and Care Co’s current strategy.

**Changes in board membership**

It seems that new NEDs need to be appointed to provide the **expertise and independence** the board is currently lacking. Corporate governance reports recommend that the board should not be so large as to be unwieldy; therefore some of the new board members may have to replace existing board members.

**Chapter 3 Internal assurance**

(a) HKSA 610 (Clarified) requires that auditors should perform an assessment of the internal audit function if they consider that it may be possible and desirable to rely on certain internal auditing work in specific audit areas for the purpose of the audit of financial statements.

When we obtain an understanding and perform a preliminary assessment of the internal audit function at Stone, we should consider the following:

**Organisational status of the internal audit department**

We would consider the specific status of the internal auditing department at Stone and the effect of this specific status on the department’s ability to be objective.

In the ideal situation, the internal auditors should report to the highest level of management and be free of any other operating responsibility.

We would carefully consider any constraints or restrictions placed on internal auditing by management.

In particular, the internal auditors should be free to communicate fully with us.

**Scope of the internal audit function**

We would consider the nature and extent of the assignments performed by the internal audit department.

We would also need to consider whether management acts on internal audit recommendations and how this is evidenced.

**Technical competence of the internal auditors**

We need to consider whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors.
We would review the policies adopted by the internal audit department for hiring and training the internal auditing staff and the experience and professional qualifications of the internal auditors.

Due professional care

We would consider whether the internal auditing function is properly planned, supervised, reviewed and documented.

We would consider the existence of adequate audit manuals, work programs and working paper.

(b) Inventory count

HKSA 501 (Clarified) requires that when stock is material to the financial statements, the auditors should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory count by themselves or another auditor or a suitably qualified person representing them, unless impracticable.

Since Stone's inventories at 31 December 20X3 were approximately 25 per cent of the company's total assets, we are obliged to attend at physical in accordance with HKSA 501(Clarified).

In exceptional circumstances the auditors may judge it necessary to depart from this procedure in order to more effectively achieve the same objective, however the auditors should document the justification for this departure in the audit working papers.

We do not consider that the availability of internal auditors at Stone's is a valid justification for departure from this procedure, even though these internal auditors are considered to be competent and sufficiently independent.

Having an internal audit function is expected of a company with sound internal controls and does not constitute an exceptional circumstance in this case.

Confirmation

Since Stone's receivables balances at 31 December 20X3 were approximately 30 per cent of the company's total assets, it is important for us to obtain reliable evidence regarding the existence of the debtors at 31 December 20X3 through external confirmation.

HKSA 505 (Clarified) requires that when performing external confirmation procedures, the auditors should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of external confirmation requests, and the responses to those requests.

The purpose of our having control over the external confirmation process is to ensure the evidence obtained from the process is sufficiently reliable for our audit purposes.

In general, audit evidence obtained directly by us is more reliable than that obtained from Stone and audit evidence from external sources is more reliable than that generated internally by Stone.

We do not consider that confirmation obtained indirectly through the internal auditors of Stone is sufficiently reliable for our audit purposes.

Non-response is a failure of the confirming party to respond or fully respond to a positive confirmation request. Auditors shall perform alternative audit procedures to obtain relevant and reliable audit evidence.

An oral response does not meet the definition of an external confirmation because it is not a direct written response to the auditor.
Chapter 4 Code of Ethics

The Code of Ethics sets out the ethical requirements in relation to independence for assurance engagements: members of assurance teams and firms must be independent from their clients.

The appointment as the reporting accountants of Super Gain and the issue of the accountants’ report is an assurance engagement. The audit firm is required to be independent of this assurance engagement.

Independence, as set out in the Code, requires both independence of mind and independence in appearance.

Independence is potentially affected by threats including: threats of self-interest, self-review, familiarity and intimidation.

The recommended professional fees of HK$1.5 million which are payable in three equal instalments with the last instalment payable only upon the successful listing of Super Gain’s shares on the Stock Exchange is structured in a contingent manner.

Contingent fees relating to an assurance engagement are an example of self-interest threat, occurring when a firm or a member of the assurance team may benefit from a financial interest in, or other self-interest conflict with, an assurance client.

In addition, an agreement with Super Gain not to charge for any additional work that might be found necessary during the flotation exercise also affects independence because of the self-interest threat, as any costs of additional work found necessary could not be recovered from Super Gain.

The agreement to participate in the Super Gain roadshow also affects independence because of the advocacy threat. This occurs when a firm may be perceived to promote an assurance client’s position or opinion such that objectivity may, or may be perceived to be, compromised. The CPA firm may be perceived as being a promoter of shares in Super Gain.

The proposal to Super Gain has to be revised, as follows:

1. The clause stating that the last instalment is payable upon the successful listing of the shares of Super Gain on the Stock Exchange has to be removed.
2. The CPA firm should be entitled to additional fees for any additional work that is found necessary during the flotation exercise.
3. The CPA firm should not participate in any activities relating to the promotion of the shares of Super Gain.
Chapter 5 Framework for assurance engagements

2 Beauchamp Avenue
Broadway
SE 5
3 December 20X5

Noble Co
413 Gilroy Road
Causeway Bay

Dear Leonard,

Thank you for your letter. I hope the following comments resolve your queries.

(a) (i) **Primary objectives of an audit**

The primary objective of the audit of a limited liability company is to **report to the shareholders** (the owners of the company) whereby the auditor expresses his opinion as to whether the accounts give a true and fair view (fairly presented) of the situation as reflected in the statement of financial position and the income statement. In addition the auditor will confirm whether in his opinion the accounts have been properly prepared with regard to applicable legislation.

(ii) **Benefits**

The main benefits are as follows:

- It gives the financial statements **credibility** and therefore gives the shareholders and third parties such as lenders confidence that the financial statements reflect fairly the position and the results of the company.
- It can result in **improvements** to the accounting system and **internal control**. In the course of the audit the auditor will often identify areas of weakness in the accounting system and internal control. These are normally reported to management in the form of a management letter at the end of the audit.
- The auditor can make recommendations regarding **business issues**. This could include matters relating to cost saving and operational efficiency.
- The audit **may prevent and detect fraud**. This is not the primary purpose of the audit or the auditor’s responsibility but the fact that an audit is to take place may discourage fraud in the first place. If it has occurred it may be detected by the auditor in the course of the audit work.

Chapter 6 Quality control

(a) In accordance with HKSA 220 (Clarified), the engagement partner should consider whether members of the engagement team have complied with ethical requirements.

The engagement partner should also form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner should:

- 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;
• promptly report any failure to resolve the matter to the firm for appropriate action; and document conclusions on independence and any relevant discussions with the firm that support these conclusions.

(b) In accordance with HKSCQ 1 (Clarified), the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, which are the Hong Kong Institute of CPA’s Statements of Professional Ethics/Code of Ethics for Professional Accountants (‘the Code’).

The Code discusses the familiarity threat to an auditor's independence. A 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.

The Code considers the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such a threat.

Accordingly, the firm should establish policies and procedures:
• 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
• For all audits of financial statements of listed entities, requiring the rotation of the engagement partner after a specified period in compliance with the Code. The Code requires the rotation of the lead engagement partner for a listed client after a pre-defined period, normally no more than seven years.

In the case of ABC, the engagement partner and the engagement manager have been serving ABC since its listing on the Hong Kong Stock Exchange in 1999. It is not likely that, under the guidelines of the Code, a familiarity threat exists.

Although it is not required by the Code, the firm may consider rotating the engagement partner in next year’s audit.

Chapter 7 Changes in auditor appointment

(a) Statutory legislation should ensure that in cases such as this, the directors would find it very difficult to dismiss the auditor. The rules should ensure that the auditor is protected from unjustified attempts to remove her from office, (while allowing a company to replace their auditor in a situation where another audit firm can offer a more efficient or effective service).

If the shareholders wish to remove the auditor, they should be able to do so at any time, simply by voting at a general meeting. A reasonable notice period is required when the auditor is being removed before the expiration of the normal term of office. Several safeguards should be in place to protect the auditor from unwarranted dismissal.
• On the receipt of the notice, the company should send a copy to the existing auditor.
• The auditor should have the right to make representations in writing, not exceeding a reasonable length, and may request that these be notified to the members.
• Upon receipt of such representations, the company should circularise copies of the representations to everyone who is entitled to receive notice of the meeting. If this is not done, then the auditor should have a right to have them read out at the meeting itself.
• The auditor should have the right to attend and be heard at the general meeting.
Any auditor who ceases to hold office should deliver a statement to the company. This must either state that there are no circumstances connected with the resignation that the auditor considers should be brought to the attention of the members and creditors of the company, or include a statement outlining such circumstances. This requirement is designed to thwart anyone’s attempt to remove the auditor in order to suppress some damaging information. This provision should apply to all changes of auditor, even where the auditor is resigning from office. This prevents the auditor from quietly resigning instead of reporting some embarrassing facts.

These measures are all designed to prevent the directors in a situation such as Dragon Ltd ‘getting rid of’ the auditor without the shareholders' knowledge.

(b) The rules do go some way to help protect the auditor's independence from the directors. In particular, they are geared towards ensuring that the auditor has the ability to communicate directly with the shareholders. However, one of the problems is that, in practice, the shareholders are likely to be strongly influenced by the directors. It is very rare for shareholders to vote against the proposals about the removal and replacement of the auditor. Directors who wish to remove an auditor will be able to invent a reason to offer to the shareholders, such as the fees being too high, or poor quality audit work. It is unlikely that the auditor will wish to engage in a public ‘showdown’ with the directors and the real reasons for the change in appointment may never become known.

Chapter 8 Planning, materiality and risk assessment

(a) Income statement items

*Revenue and gross profit*

Revenue for the year 20X4 increased from HK$700 million last year to HK$800 million. An increase of 14.3 per cent is noted.

Gross profit for the year decreased from HK$100 million last year to HK$80 million, despite a sales increase of 14.3 per cent or HK$100 million during the year.

The decrease in unit selling price from HK$14,000 last year to HK$10,000 in 20X4 may suggest a net realisable problem on the closing inventory.

Taxation for the year was HK$3 million as compared to HK$13 million last year. The decrease in taxation is not in line with the decrease in profit before taxation.

The effective tax rate for the year 20X4 is 6 per cent compared with 17.8 per cent in 20X3. Since the company's business is in Hong Kong, the effective tax rate of 6% suggests taxation for the year may be understated.

(b) Statement of financial position items

The inventories balance increased from HK$20 million at 31 December 20X3 to HK$80 million at 31 December 20X4. The increase in inventories is much more than the increase in sales during the year.

With inventories turnover days increased from 9 days \(\frac{((10 + 20)/2)\times 365}{600} \) to 25 days \(\frac{((20 + 80)/2)\times 365}{720} \) in 20X4, inventories at year-end may have a valuation problem. Greater emphasis should be placed on the audit of the valuation of year-end inventories.

Trade receivables increased from HK$60 million at 31 December 20X3 to HK$150 million at 31 December 20X4, an increase which is not in line with the increase in sales during the year of only 14.3 per cent. Receivables turnover days increased from 31 days \(\frac{60/700 \times 365}{70/610 \times 365} \) to 68 days \(\frac{150/800 \times 365}{70/610 \times 365} \). Prolonged credits offered to customers may indicate unusual risks regarding the assertion of valuation of trade receivables.

Trade payables increased from HK$70 million at 31 December 20X3 to HK$150 million at 31 December 20X4. Payables turnover days increased from 42 days \(\frac{70/610 \times 365}{70/610 \times 365} \) to 70
days \((150/780 \times 365)\). The increase in payables turnover days may suggest Complex has to delay payment to suppliers to keep sufficient working capital.

As identified above, taxation for the year may be understated and hence, tax payable at 31 December 20X4 is also understated.

**Going concern**

The net current asset of Complex has decreased from HK$70 million to HK$20 million.

This suggests that Complex is experiencing a liquidity problem which may cast doubt on the entity as a going concern. The current ratio decreased from 1.64 at 31 December 20X3 to 1.08 at 31 December 20X4 and the quick ratio decreased from 1.45 at 31 December 20X3 to 0.76 at 31 December 20X4.

Emphasis should be placed on how the entity addresses the going concern issue. Complex's cash flow projection should be obtained and discussion should be held with management on the basis of the projection and any plan to improve the liquidity issue identified during the planning process.

**Chapter 9 Audit evidence, procedures, audit methodologies and audit sampling**

(a) HKSA 530 (Clarified) *Audit Sampling and Other Means of Testing* states that audit sampling involves the application of audit procedures to less than 100 per cent of items within a class of transactions or an account balance such that all sampling units have a chance of selection.

Sampling risk arises from the possibility that A & B's conclusion, based on a sample, may be different from the conclusion reached if the entire population were subject as to the same audit procedures.

Non-sampling risk arises from factors that cause A & B to reach an erroneous conclusion for any reason not related to the size of the sample, eg A & B might use inappropriate audit procedures, or A & B might misinterpret audit evidence and fail to recognize an error.

For both tests of controls and substantive test of details (0.5), sampling risk can be reduced by increasing sample size (0.5), while non-sampling risk can be reduced by proper engagement planning supervision and review (0.5).

(b) In performing substantive audit procedures (tests of details), a class of transaction or account balance may be stratified by monetary value. Therefore, A & B may stratify the outlets by the balances of cash floats (eg <$10,000 and $10,000+) and perform the substantive audit procedures on larger value items which may contain the greatest potential monetary error in terms of overstatement. However, it is important to make sure that the remaining part of the population (which is not tested) is not material. If it is material, samples from the remaining population should also be tested.

When there is a wide range (variability) in the monetary size of items in the population, it may be useful to group items of similar size into separate sub-populations or strata.

When a population can be appropriately stratified, the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

In other words, the effectiveness of A & B's substantive audit procedures is higher when the sample (say 5 outlets) is chosen from the larger value items ($10,000+) compared to the sample (of 5 outlets also) being drawn from all 20 outlets.
Chapter 10 Fraud and irregularities

(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 and the risk of material misstatement of the completeness assertion of staff costs and bank and 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 and 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) the Auditor’s Procedures in Response to Assessed Risks, 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.

Chapter 11 Internal control and tests of controls
Test of controls on cash till reconciliation
- Inquire of the shop supervisor how he/she reviews and approves the daily cash till reconciliation.
- Reconcile the cash till balance with the receipts from cash and credit cards less payment for the outlet's routine expenses.
- Observe the application of this control by asking the shop supervisor to demonstrate how he/she performs the control. The supervisor should demonstrate it based on reconciliations that he/she has reviewed.
- Based on the reconciliations selected in the above step, inspect the cash receipts and credit sales to bank statements and cash payments of expenses to supplier invoices. The purpose is to test whether the supervisor has controlled the daily cash till effectively.
- Observe the cash count at a selection of outlets when making surprise visits.
Chapter 12 Substantive procedures, including analytical procedures

(a) The most important financial statement assertion tested in:

Situation 1
Existence of inventories
Valuation and allocation of inventories – limited to the details that can be observed and confirmed.

Situation 2
Existence of inventories
Valuation and allocation of inventories – limited to the details that can be observed.

Situation 3
Completeness of trade payables
Rights and obligations of trade payables.

Situation 4
Existence of bank balance
Valuation and allocation of bank balance.
Rights and obligations of bank balance.

(b) More persuasive sources of evidence in:

Situation 1
Source A, observation of the counting of the client's inventory, is more persuasive because:

(1) the auditor obtains the evidence directly (including the effectiveness and reliability of counting procedures by the client); and

(2) although the warehouse is independent, there may be questions about their competence and integrity. In addition, some warehouses do not have strong internal control and reporting systems for them to readily respond to such requests.

Situation 2
Source B, physical examination of the metal sheets, is more persuasive because:

(1) it is easier to count and identify;

(2) the grade/quality is usually marked on metal sheets; and

(3) there are generally no major obsolescence problems with metal sheets. However, the nature and quality of sophisticated electronic equipment are more difficult to ascertain.

Situation 3
Source B, request for suppliers’ confirmations, is more persuasive if the auditor has sufficient information to contact all major suppliers and most suppliers respond to the auditor’s request. Confirmations are an independent source of evidence.

Many auditors use the first approach (Source A) by examining payments subsequent to the year-end, which can still provide reasonable assurance if the client pays its bills on a regular and timely basis and has sufficient controls to ensure that all bills are identified for payment and if there is no particular risk of overstatement of trade payables.

Situation 4
Source A, confirmation of the year-end bank balance, is more persuasive because:

(1) the confirmation is an external source of evidence; and
(2) the confirmation can provide more comprehensive information than bank statements, such as liens on assets and contingent liabilities.

Chapter 13 Specific audit procedures

- Obtain confirmation from the bank of the amount of the loan and the interest and repayment terms.
- Examine the loan agreement for terms and conditions and ensure compliance with relevant terms in the loan covenant.
- Check the classification in the financial statements of current liabilities and non-current liabilities, based on the repayment terms.
- Check the calculation of interest expenses appearing in the profit and loss account and agree the interest to bank advice and/or bank letters.
- Confirm that the treatment of interest is consistent with the loan agreement, and correctly disclosed as a finance expense.
- Check the extent of any security for the loan and that the existence and extent of the security has been disclosed.

Chapter 14 Using the work of others

(a) It is not necessary to use an auditor's expert to audit the useful lives of the platforms as there are many other available sources of evidence. Relevant procedures include:

(i) Obtaining weather reports to see whether management's determination of useful lives is consistent with them

(ii) Comparing budgeted oil against actual oil extracted (if the budget was optimistic, so might the useful life be)

(iii) Reviewing published industry comparators (such as Shell and BP). If the useful lives of their platforms as published in financial statements is significantly different, discuss with management why that might be

(iv) Considering whether management's determination of useful lives in the past has been proved accurate

(b) It is not necessary to use an auditor's expert, as the question states that a 'simple' test is available.

The auditors should confirm that the company will be making use of this test during the inventory count to separate the inventory. The auditor should reperform the test on a sample of 'brass' and 'copper' as counted to ensure it has been separated correctly.

Chapter 15 Accounting estimates, opening balances and comparatives

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.

Chapter 16 Overall audit review and finalisation

The strike is a subsequent event under HKSA 560 (Clarified) since it is an event occurring after the reporting date. In particular, it is 'an event occurring up to the date of the auditor's report' since it occurred before the date of the auditor's report.

In accordance with HKSA 560, (Clarified) KTT & Co should consider the effect of the strike on the financial statements and on the auditor's report.

Since KTT & Co has performed all the audit work and procedures that are necessary to comply with the auditing standards, KTT & Co should have already performed the typical audit procedures for events occurring up to the date of the auditor's report.

The strike may however raise concerns as to whether the procedures performed by KTT & Co during the audit process were adequate and, if not, what further procedures are required.

In response to the payment delay and labour strike, KTT & Co should perform the following procedures:

(1) Confirm with the management that GN has actually delayed salary payments to the 25 staff and inquire of the management the reasons for the delay.

(2) Inquire of management whether there have been other cases of salary delay besides these.

(3) Inquire of management whether GN would settle the outstanding amount before issuing the financial statements, and inspect documentary evidence for any settlement of the amounts due.
Re-consider the risk assessments made during the audit process to determine whether they remain valid. If the previous risk assessments are no longer valid, eg the integrity of the management is questionable since they deliberately concealed the facts about the delay in salary payment when KTT & Co performed the typical procedures on subsequent events, KTT & Co may need to revise the risk assessment and consider the effect on the audit procedures and the auditor's report.

Re-consider the management's assessment about GN's ability to operate as a going concern. This includes the following:

1. Consider whether GN is able to settle the amount due and how GN will finance the settlement;
2. Find out whether the strike and staff resignations would affect GN's daily operations;
3. Review the management plan to prevent similar liquidity and labour issues from occurring;
4. Obtain sufficient evidence to confirm or dispel the view that a material uncertainty about GN's going concern exists, eg new funding from shareholders or extension of bank credit;
5. Consider any other mitigating factors;
6. Obtain confirmation of the management's plan.

Consider the effect of the salary payment delay and labour strike after the year end on the auditor's report. This includes determining:

1. whether the facts should be disclosed in the financial statements and whether the disclosure is adequate in drawing financial statement users' attention to material uncertainty;
2. whether the report should be modified by adding an emphasis of matter paragraph [HKSA 706 (Clarified)], or other forms of modification as appropriate.

Chapter 17 Audit reporting

(a) The types of auditors’ opinions that may be expressed in the auditors' report may be:

(i) Unqualified; or
(ii) Modified:

(1) matters that do not affect the auditors' opinion; and
(2) matters that do affect the auditors' opinion.

Modified reports for matters that do not affect the auditors' opinion – fundamental uncertainty

In accordance with HKSA 700 (Clarified), the auditors should, in forming the audit opinion on financial statements of QQ Laundry Ltd ('QQ'), consider whether the view given by the financial statements could be affected by inherent uncertainties which, in their opinion, are fundamental.

Inherent uncertainties about the outcome of future events frequently affect a wide range of components of the financial statements at the date they are approved. It is not possible for the management of QQ to remove the uncertainties over the loss-making shop by obtaining more information at the date they approve the financial statements.

The financial statements can reflect only the working assumptions of directors as to the financial outcome of inherent uncertainties (ie the value of the washing machines and dryers to the business is greater than $500,000 when the shop is profitable) and, where material, describe the circumstances giving rise to the uncertainties and their potential financial effect.
In determining whether the inherent uncertainty over the loss-making shop is fundamental, the auditors of QQ should consider:

• the risk that the estimate included in the financial statements may be subject to change;
• the range of possible outcomes; and
• the consequences of those outcomes on the view shown in the financial statements.

Inherent uncertainties are regarded as fundamental when they involve:

• a significant level of concern about the validity of the going concern; or
• other matters whose potential effect on the financial statements is unusually great.

Depending on the various factors mentioned above, the inherent uncertainty regarding the value of tangible non-current assets in the loss-making shop could be considered as fundamental to the financial statements. However, if the disclosure made in the financial statements by the management of QQ, and the audit evidence obtained on this matter are such that the auditor is satisfied that the financial statements give a true and fair view, the audit opinion will be unqualified but will contain an explanatory paragraph describing the fundamental uncertainty. The ‘fundamental uncertainty’ paragraph will explain that the value of certain tangible fixed assets is uncertain and refer to the disclosures made in the financial statements. The ‘fundamental uncertainty’ paragraph will end with ‘our opinion is not qualified in this respect’.

(Candidates are free to express a different view with adequate reasons and explanations, eg HKSA 510 (Clarified).)

(b) In accordance with HKSA 705 (Clarified), since the auditors disagree with the management’s assessment of the uncertainties over the tangible assets at the loss-making shop, and the effect of that disagreement is material to the financial statements, the auditors should include in the opinion section of their report:

• a description of all substantive factors giving rise to the disagreement;
• the implications of these factors for the financial statements; and
• whenever practicable, a quantification of the effect on the financial statements.

When the auditors conclude that the effect of the matter giving rise to disagreement is so material or pervasive that the financial statements are seriously misleading, the auditors should issue an adverse opinion.

In the case of other material disagreements, the auditor should issue a qualified (except for disagreement) opinion indicating that it is expressed except for the effects of the matter giving rise to the disagreement (ie the washing machines and dryers are worth nothing if the loss-making shop is closed).

(Candidates are free to express a different view with adequate reasons and explanations.)

Chapter 18 Group audits

(a) Inter-company balances should agree because, in the preparation of consolidated accounts, it is necessary to cancel them out. If they do not cancel out then the group financial statements will be displaying an item which has no value outside of the group and profits may be correspondingly under- or over-stated. The audit work required to check that inter-company balances agree would be as follows.

(i) Obtain and review a copy of the holding company’s instructions to all group members relating to the procedures for reconciliation and agreement of year end inter-company balances. Particular attention should be paid to the treatment of ‘in transit’ items to ensure that there is a proper cut-off.

(ii) Obtain a schedule of inter-company balances from all group companies and check the details therein to the summary prepared by the holding company. The details on these
schedules should also be independently confirmed in writing by the component auditors.

(iii) Nil balances should also be confirmed by both the group companies concerned and the component auditors.

(iv) The details on the schedules in (iii) above should also be agreed to the details in the financial statements of the individual group companies which are submitted to the holding company for consolidation purposes.

(b) Where one company in a group supplies goods to another company at cost plus a percentage, and such goods remain in inventory at the year end, then the group inventories will contain an element of unrealised profit. In the preparation of the group financial statements, best accounting practice requires that a provision should be made for this unrealised profit.

In order to verify that inter-company profit in inventory has been correctly accounted for in the group accounts, the audit work required would be as follows.

(i) Confirm the group’s procedures for identification of such inventories and their notification to the parent company who will be responsible for making the required provision.

(ii) Obtain and review schedules of inter-group inventories from group companies and confirm that the same categories of inventory have been included as in previous years.

(iii) Select a sample of invoices for goods purchased from group companies and check to see that as necessary these have been included in year end inter-group inventories and obtain confirmation from component auditors that they have satisfactorily completed a similar exercise.

(iv) Check the calculation of the provision for unrealised profit and confirm that this has been arrived at on a consistent basis with that used in earlier years, after making due allowance for any known changes in the profit margins operated by various group companies.

(v) Check the schedules of inter-group inventory against the various inventory sheets and consider whether the level of inter-group inventories appears to be reasonable in comparison with previous years, ensuring that satisfactory explanations are obtained for any material differences.

Chapter 19 Audit-related services and other assurance engagements

(a) The first problem is that this is a high risk audit. The entity is small and under the direct control of three shareholder/directors. It is highly unlikely that there will be significant control systems beyond the direct observation and supervision imposed by the directors. This may well impair the evidence that is available from substantive tests as well as internal control. Small entities can have effective control systems, but they are likely to be implemented differently from those in larger businesses.

This is also a high risk audit in terms of global inherent risks. The company is expanding and wishes to raise a loan. That could put the directors under pressure to distort the results of the statement of financial position and cash flows of the company. The auditor will have to take particular care in testing the non-current assets and the elements of working capital. The directors are under a certain amount of pressure to manipulate those areas.
This is a new audit. There is no prior knowledge or experience of the business. The auditor has not had an opportunity to assess the competence or the integrity of management. It will be difficult to determine whether the figures in the draft financial statements appear valid or sensible because past statements will not have been audited.

The circumstances described in the two preceding paragraphs also raise concerns about the extent to which the auditor can rely on management representations.

The terms of this engagement make it rather more sensitive than normal. The bank is clearly going to look to the auditor for a duty of care. The auditor will have to determine the basis on which the statements are to be prepared and reported on. Is this normal accounting convention or some specialised approach to reporting that is favoured by the bank (eg more conservative than usual)? The extent to which the auditor is reporting to the bank as opposed to the shareholders should be determined and agreed upon in writing. The auditor should also determine whether the bank wishes any specific tests to be conducted.

The auditor will have to document any and all matters that involve professional judgement with particular care. This audit report could well be the subject of some dispute at a later date and the audit working papers will be the only way to defend any allegations of negligence.

(b) The auditor is almost certainly liable to the bank. The report described by the directors is apparently to be addressed to the bank.

The auditor can mitigate this responsibility by taking care in the wording of the report. The independent accountant's report could indicate the extent to which the figures have been checked and tested. If the evidence gathered leaves scope for uncertainty as to the accuracy of the results then that can be made clear. It should also be made clear that the bank should take care to establish the basis on which the figures have been prepared and presented. That could have implications for whether they form a suitable basis for the lending decision. If the auditor feels that further investigations should be made by the bank then that should be made clear.

Chapter 20 Information technology

(a) The main safeguard within an on-line real-time computer system in a large corporation is the use of passwords.

The passwords should be confidential and subject to frequent change.

The more sensitive the application, the more passwords would be required, and would operate in a so-called hierarchical system. Passwords should be supplemented by physical controls over access to terminals, and may where appropriate be supplemented by such techniques as voice or fingerprint recognition.

Terminals should be logged off automatically if left unattended for more than a short period. They should also close down if a number of unsuccessful attempts at access are made, as these may be the work of an unauthorised person attempting to access the system. All unauthorised access attempts should be logged.

Input data should be logged to provide an audit trail, e.g. by means of a regular printout at the terminal or a record at the point of input.

Programs should be regularly checked to ensure they have not been altered.

Back-up files should be used to prevent corruption of data by unauthorised input.

Other typical controls include:

• Programming controls
• Transaction logs
• Firewalls
• Pre-processing authorisation
• Terminal device edit, reasonableness and other validation tests
• Input error reporting and handling
• Cut-off procedures
• File controls
• Master file controls
• Other controls identified

(b) Reasons for weaknesses in small entities’ stand-alone PC systems:

Small entities generally have few staff, so that it will often be difficult to create good conditions for segregation of duties. The accountant, for instance, may be the only person in the entity fully conversant with the accounting system. This weakens security and problems may arise if the computer ‘expert’ is on leave. If one person has specialised programming knowledge not shared by others, he or she may be able to put through unauthorised programmed changes undetected.

Controls over access to the system may be poor or non-existent. In a small office, it will probably be difficult to create physical security by putting the computer in a secure area. Controls over programs and disks may also be poor.

Clerical staff in a small entity may be required to use the computer for routine processing without an understanding of the system or of its possible risks and pitfalls. If a malfunction occurs or if an error is made, untrained staff may not be able to take appropriate corrective action, and there is a risk that files may be corrupted or data lost as a result.

Poor access controls, may result in poor control over input; and there is a risk that data may be input twice or not at all.

Small entities with few resources may not have made adequate provision for maintenance or stand-by equipment in case of breakdown or damage.

(c) Stand-alone PCs can be operated by a single user or many users at different times accessing the same or different programs on the same computer. The user of a stand-alone PC that processes accounting applications performs many functions. While typically not knowledgeable about programming, users may often use third-party or off-the-shelf software packages such as spreadsheets or database applications.

General controls refer to the environment within which computer applications are developed, maintained and operated, and within which the application controls operate.

In a typical stand-alone PC environment, the level of general controls is lower than what would be found in a large-scale computing environment. Nevertheless, selected security and control procedures can help improve the overall level of internal control.

The control procedures implemented relate to the complexity of the business environment in which the PC operates. In general, the stand-alone PC environment is less structured than a centrally controlled IT environment.

The auditors need to obtain an understanding of the client’s system and identify the extent to which it contains general controls upon which reliance can be placed.

In a stand-alone PC environment, it may not be practical or cost-effective for management to implement sufficient controls to reduce the risks of undetected errors to a minimum level.

Having conducted a review and evaluation of the software and procedures in use, the auditors may identify such controls. If the auditors find it more cost-effective not to make a further review of general or application controls, but to concentrate audit efforts on substantive procedures, this may entail more extensive physical examination and confirmation of assets, more tests of transactions, a larger sample size and greater use of computer-assisted audit techniques.
Question bank – questions
CASE STUDY 1

Hong Kong Manufacturing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Manufacturing Company Limited and its subsidiaries (‘HKM’) are principally engaged in the manufacture and distribution of garment and apparel products. All HKM’s production facilities are located in Mainland China. HKM’s operating results in the last five years are summarised as follows:

<table>
<thead>
<tr>
<th></th>
<th>2008 (Draft) HK$'m</th>
<th>2007 HK$'m</th>
<th>2006 HK$'m</th>
<th>2005 HK$'m</th>
<th>2004 HK$'m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>3,322</td>
<td>2,488</td>
<td>2,045</td>
<td>1,368</td>
<td>975</td>
</tr>
<tr>
<td>Operating profit</td>
<td>400</td>
<td>353</td>
<td>349</td>
<td>167</td>
<td>56</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>335</td>
<td>283</td>
<td>255</td>
<td>132</td>
<td>33</td>
</tr>
</tbody>
</table>

The draft summary of the financial position of HKM as at 31 December 2008 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2008 HK$'m</th>
<th>2007 HK$'m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible assets</td>
<td>150</td>
<td>52</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>547</td>
<td>446</td>
</tr>
<tr>
<td>Other non-current assets</td>
<td>42</td>
<td>86</td>
</tr>
<tr>
<td>Inventories</td>
<td>486</td>
<td>282</td>
</tr>
<tr>
<td>Trade and other receivables</td>
<td>704</td>
<td>479</td>
</tr>
<tr>
<td>Bank balances and cash</td>
<td>580</td>
<td>567</td>
</tr>
<tr>
<td>Other current assets</td>
<td>106</td>
<td>36</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>2,615</strong></td>
<td><strong>1,948</strong></td>
</tr>
<tr>
<td>Equity</td>
<td>1,903</td>
<td>1,556</td>
</tr>
<tr>
<td>Long-term bank loans</td>
<td>14</td>
<td>7</td>
</tr>
<tr>
<td>Taxation payable</td>
<td>79</td>
<td>49</td>
</tr>
<tr>
<td>Bank overdrafts</td>
<td>68</td>
<td>11</td>
</tr>
<tr>
<td>Trade and bills payable</td>
<td>377</td>
<td>228</td>
</tr>
<tr>
<td>Accruals and other payables</td>
<td>174</td>
<td>97</td>
</tr>
<tr>
<td><strong>Total equity and liabilities</strong></td>
<td><strong>2,615</strong></td>
<td><strong>1,948</strong></td>
</tr>
</tbody>
</table>

You are a manager at XYZ & Co., HKM's auditor since its listing in 2006. You are the manager-in-charge of the audit of HKM's financial statements for the year ended 31 December 2008.

**Question 1**

You are giving a pre-audit meeting briefing to your team members.

Required

Explain the responsibility of the engagement team/partner in complying with the quality control requirements:

(i) in engagement acceptance;
(ii) during engagement performance; and
(iii) before issuing the auditor's report on HKM's 2008 financial statements.  (12 marks)
Question 2

Your team assessed the inherent risks of material misstatement at the assertion level of revenue from sales of goods as normal for all assertions and were able to rebut the presumed risk of fraud in revenue recognition. After taking into consideration the design and implementation of HKM's internal controls over revenue transactions, your team assessed the risks of material misstatement at the assertion level as low for all assertions with an expectation of the operating effectiveness of the internal controls. You instruct your assistants to perform tests of details on a sample of sale transactions for the occurrence of sale transactions, concurrently with tests of controls on revenue transactions to confirm your team's expectation of the operating effectiveness of the internal controls.

**Required**

(a) Determine how the sample size for the tests of details would be affected:
   (i) by audit materiality at a given level of assessed risk; and
   (ii) the assessed low risk at a given level of audit materiality.  

(b) Determine how your team should respond if the delivery notes and customer invoice for one of the sample units were found missing and the client was not able to locate the missing documents.

Question 3

Mr Lee, the Managing Director of HKM, has asked your team to rely on some of the work which is regularly performed or will be performed by HKM's internal auditors for the purpose of carrying out the audit of HKM's 2008 financial statements. Particularly, Mr Lee has suggested your team to rely on the following work, which is regularly performed or will be performed by HKM's internal auditors:

(i) year-end physical inspection of the property, plant and equipment; and
(ii) on-going monitoring activities of the completeness of acquisition of merchandise from suppliers.

**Required**

(a) When your team intends to use the work of HKM's internal auditors, how would your team evaluate their work?

(b) Explain whether your team would use the work of HKM's internal auditors in the specific ways suggested by Mr Lee.

Question 4

Included in HKM's accruals and other payables of HK$174,000,000 at 31 December 2008 is an estimate of losses from a personal injury claim against the company in the amount of HK$4,305,200. You are checking the adequacy of this provision.

**Required**

Explain the main approaches with detailed steps in auditing the adequacy of this HK$4,305,200 provision, quoting the relevant auditing standard where applicable. 

(Total = 50 marks)
CASE STUDY 2

Initially established in the mid-1990s, 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 one hundred 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 2008, 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 2007 in ZZZ’s annual general meeting.

In August 2008, 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 2007.

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 2007 and the unaudited management accounts for the 8 months ended 31 August 2008. Ms Or has extracted certain figures from the financial statements and management accounts for analysis as follows:

**Income statement**

<table>
<thead>
<tr>
<th></th>
<th>Extracted from management accounts (1 January 2008 to 31 August 2008) HK$’000</th>
<th>Extracted from audited financial statements (Year ended 31 December 2007) HK$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue (Note 1)</td>
<td>700,459</td>
<td>802,009</td>
</tr>
<tr>
<td>Gross profit</td>
<td>100,237</td>
<td>170,394</td>
</tr>
<tr>
<td>Net profit before tax</td>
<td>72,004</td>
<td>71,370</td>
</tr>
</tbody>
</table>

**Statement of financial position**

<table>
<thead>
<tr>
<th></th>
<th>Extracted from management accounts (at 31 August 2008) HK$’000</th>
<th>Extracted from audited financial statements (at 31 December 2007) HK$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventories</td>
<td>340,501</td>
<td>231,092</td>
</tr>
<tr>
<td>Accounts receivable (Note 2)</td>
<td>287,094</td>
<td>197,290</td>
</tr>
<tr>
<td>Impairment of receivables</td>
<td>(2,000)</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Current assets</td>
<td>901,294</td>
<td>725,190</td>
</tr>
<tr>
<td>Net assets</td>
<td>792,029</td>
<td>401,821</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,592,091</td>
<td>800,284</td>
</tr>
</tbody>
</table>
**Note 1**: Monthly analysis of sales revenue

<table>
<thead>
<tr>
<th></th>
<th>2008 HK$'000</th>
<th>2007 HK$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>81,039</td>
<td>64,612</td>
</tr>
<tr>
<td>February</td>
<td>98,156</td>
<td>65,516</td>
</tr>
<tr>
<td>March</td>
<td>97,209</td>
<td>65,201</td>
</tr>
<tr>
<td>April</td>
<td>96,411</td>
<td>67,503</td>
</tr>
<tr>
<td>May</td>
<td>81,039</td>
<td>65,027</td>
</tr>
<tr>
<td>June</td>
<td>82,919</td>
<td>67,287</td>
</tr>
<tr>
<td>July</td>
<td>83,493</td>
<td>70,383</td>
</tr>
<tr>
<td>August</td>
<td>80,193</td>
<td>69,008</td>
</tr>
<tr>
<td>September</td>
<td>0</td>
<td>70,182</td>
</tr>
<tr>
<td>October</td>
<td>0</td>
<td>67,263</td>
</tr>
<tr>
<td>November</td>
<td>0</td>
<td>63,243</td>
</tr>
<tr>
<td>December</td>
<td>0</td>
<td>66,784</td>
</tr>
<tr>
<td>Total</td>
<td>700,459</td>
<td>802,009</td>
</tr>
</tbody>
</table>

**Note 2**: Aging analysis of accounts receivable

<table>
<thead>
<tr>
<th>Age</th>
<th>Extracted from management accounts (at 31 August 2008) HK$'000</th>
<th>Extracted from audited financial statements (at 31 December 2007) HK$’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 60 days</td>
<td>105,517</td>
<td>115,090</td>
</tr>
<tr>
<td>61 to 90 days</td>
<td>62,908</td>
<td>37,001</td>
</tr>
<tr>
<td>91 to 180 days</td>
<td>57,984</td>
<td>36,219</td>
</tr>
<tr>
<td>181 to 365 days</td>
<td>38,980</td>
<td>8,980</td>
</tr>
<tr>
<td>Over 1 year</td>
<td>21,705</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>287,094</td>
<td>197,290</td>
</tr>
</tbody>
</table>

**Question 1** 32 minutes

(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)

**Question 2** 26 minutes

Assume that Gold and Silver has accepted the audit engagement.

(a) Evaluate the risk of material misstatement relating to the existence assertion of ZZZ’s inventories as at 31 December 2008. (3 marks)

(b) Explain the audit procedures Ms Or should perform in response to the assessed risk of material misstatement relating to the existence assertion of ZZZ’s inventories as at 31 December 2008. (6 marks)

(c) Discuss Gold and Silver’s responsibilities regarding the carrying amount of ZZZ’s inventories as at 31 December 2007. (5 marks)
Question 3  
14 minutes
Assume that Gold and Silver has accepted the audit engagement. In mid-December 2008, Ms Au left a telephone message for Ms Or enquiring about the auditor’s view of the adequacy of the HK$ 2 million impairment of receivables on ZZZ’s financial statements. Before returning the call, briefly explain what Ms Or should consider in relation to this enquiry. How does a review of an interim financial report differ from an audit of financial statements? (8 marks)

Question 4  
18 minutes
ZZZ also appointed Gold and Silver to review and report on the interim financial report of ZZZ for the six months ended 30 June 2008.

Required
(a) How does a review of an interim financial report differ from an audit of financial statements? (3 marks)
(b) Explain Gold and Silver’s responsibility for other information that accompanies ZZZ’s interim financial report. (7 marks)

(Total = 50 marks)

HKICPA September 2008 (amended)
CASE STUDY 3

Hong Kong Printing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Printing Company Limited and its subsidiaries (‘HKP’) are principally engaged in the manufacture and printing of multi-colour packing products, boxes, books, brochures and other paper products. All HKP’s production facilities are located in Mainland China.

2007 was a very difficult year for HKP. HKP reported a loss, for the first time since its incorporation 30 years ago, of HK$23 million. The loss was caused by a drop in sales due to intense market competition, coinciding with increases in variable costs in raw materials and wages.

HKP’s operating results in the last five years are as follows:

<table>
<thead>
<tr>
<th>year</th>
<th>Revenue</th>
<th>Operating profit/(loss)</th>
<th>Finance costs</th>
<th>Profit/(loss) after tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>423,044</td>
<td>(5,371)</td>
<td>(8,889)</td>
<td>(23,151)</td>
</tr>
<tr>
<td>2006</td>
<td>471,222</td>
<td>14,312</td>
<td>(7,975)</td>
<td>(3,973)</td>
</tr>
<tr>
<td>2005</td>
<td>435,421</td>
<td>32,265</td>
<td>(10,521)</td>
<td>16,999</td>
</tr>
<tr>
<td>2004</td>
<td>451,420</td>
<td>28,759</td>
<td>(10,879)</td>
<td>11,118</td>
</tr>
<tr>
<td>2003</td>
<td>425,345</td>
<td>24,487</td>
<td>(12,038)</td>
<td>8,355</td>
</tr>
</tbody>
</table>

Because of the unexpectedly poor operating results, HKP experienced extremely severe operating cash flow problems during the year. HKP delayed paying interest to its major banks in accordance with the loan agreements. As a result of these breaches of covenants, the bank loans became repayable immediately. HKP’s management obtained informal understandings from the relevant account managers of the banks that in view of the long term relationship with HKP the banks would not require HKP to repay the loans immediately. However, no formal confirmation of these waivers had been obtained from the banks. The management of HKP was not aware of the financial reporting requirement to reclassify such loans as current when they prepared the draft financial statements for the year ended 31 December 2007.

The draft consolidated statement of financial position of HKP as at 31 December 2007 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HK$’000</td>
<td>HK$’000</td>
</tr>
<tr>
<td>Pre-paid land lease premium</td>
<td>30,695</td>
<td>31,202</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>409,339</td>
<td>350,359</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>440,034</td>
<td>381,561</td>
</tr>
<tr>
<td>Inventories</td>
<td>78,788</td>
<td>106,259</td>
</tr>
<tr>
<td>Trade and other receivables</td>
<td>85,555</td>
<td>104,443</td>
</tr>
<tr>
<td>Bank balances and cash</td>
<td>33,918</td>
<td>48,060</td>
</tr>
<tr>
<td>Current assets</td>
<td>198,261</td>
<td>258,762</td>
</tr>
<tr>
<td>Total assets</td>
<td>638,295</td>
<td>640,323</td>
</tr>
<tr>
<td>Share capital</td>
<td>22,255</td>
<td>22,255</td>
</tr>
<tr>
<td>Reserves</td>
<td>221,579</td>
<td>244,730</td>
</tr>
<tr>
<td>Equity</td>
<td>243,834</td>
<td>266,985</td>
</tr>
</tbody>
</table>
You are a manager at XYZ & Co, HKP's auditor since its incorporation. You have been the manager-in-charge of audits of HKP's financial statements for the last 5 years.

**Question 1**

You are performing certain preliminary engagement activities for the audit of HKP's financial statements for the year ended 31 December 2007 (‘2007 audit’), including the development of an overall audit strategy, and an assessment of the risk of material misstatement at the financial statement level.

**Required**

Determine:

(a) the ethical issues your team should consider in deciding whether your firm should continue the client relationship with HKP and accept the 2007 audit engagement; and

(b) the overall response and any relevant audit procedures in response to your preliminary assessment that the risk of material misstatement at the financial statement level due to fraud and error is low.

**Question 2**

You consider that the whole amount of long-term bank loans in HKP's draft consolidated statement of financial position should be reclassified as a current liability. After you raised this issue to the management of HKP, they obtained formal confirmation of the waivers from the banks for the breaches of covenants in 2007 and have disclosed the details of the breaches and waivers in Note 1(c) of the revised draft of financial statements. On this basis, the management of HKP disagreed with your request to reclassify the loans as current. Also, the engagement partner is unsure of the correctness of your proposed re-classification because he remembered a similar case a few years ago which did not necessitate re-classification under the accounting standards applicable at that time.

**Required**

Regarding the proper classification of bank loans as current and non-current:

(a) assess the risk of material misstatement at the assertion level;  

(b) explain whether your audit approach in this particular case may be different from a typical situation, and determine the further audit procedures you would perform in response to the assessed risk; and
determine how your team would resolve the differences in opinion amongst team members and with HKP in accordance with the quality control standards. (4 marks)

Question 3 18 minutes

In auditing HKP’s financial statements for the last year, you have assessed the risk of material misstatement of all the assertions of HKP’s trade and other payables as low, with the expectation that HKP’s controls over trade and other payables are operating effectively and have performed tests of controls to confirm your expectation.

Required

Regarding the completeness of trade and other payables of HKP’s financial statements for the current year:

(a) assess the risk of material misstatement at the assertion level; and (3 marks)

(b) determine the most efficient audit approach and briefly describe the further audit procedures your team would perform in response to the assessed risk.

[For the purpose of this part, you should determine the audit approach, discuss the timing of the further audit procedures and give not more than three examples of further audit procedures you would perform.] (7 marks)

Question 4 22 minutes

Assume that HKP finally reclassified the bank loans as current liabilities.

Required

(a) Determine whether the use of the going concern assumption in this case is appropriate. Explain the procedures you would perform before coming up with your conclusion; and (7 marks)

(b) Advise the engagement partner of any modification your firm should make in the auditor’s report and draft the modification. (5 marks)

(Total = 50 marks)

HKICPA February 2008 (amended)
CASE STUDY 4

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 2006, 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 revenues 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 sales and receivables has been noted.

On 21 December 2006, 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 2006 after it reported on EMM's financial statements for the year ended 31 December 2005. However, XYZ & Co resigned in November 2006.

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 2007 and proposed to appoint them as the auditor of EMM's financial statements for the year ended 31 December 2006.

(i) EMM's consolidated statement of financial position at 31 December 2006 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>515,661</td>
<td>476,838</td>
</tr>
<tr>
<td>Lease premium on land</td>
<td>176,140</td>
<td>45,208</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>8,862</td>
<td>4,773</td>
</tr>
<tr>
<td>Goodwill</td>
<td>14,086</td>
<td>14,086</td>
</tr>
<tr>
<td>Prepayments and deposits</td>
<td>168,442</td>
<td>84,144</td>
</tr>
<tr>
<td>Deferred tax assets</td>
<td>15,309</td>
<td>14,391</td>
</tr>
<tr>
<td><strong>Non-current assets</strong></td>
<td><strong>898,500</strong></td>
<td><strong>639,440</strong></td>
</tr>
<tr>
<td>Current portion of lease premium on land</td>
<td>3,819</td>
<td>1,067</td>
</tr>
<tr>
<td>Inventories</td>
<td>80,931</td>
<td>87,143</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>936,370</td>
<td>817,126</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>1,220,018</td>
<td>1,064,385</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td><strong>2,241,138</strong></td>
<td><strong>1,969,721</strong></td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>3,139,638</strong></td>
<td><strong>2,609,161</strong></td>
</tr>
</tbody>
</table>
(ii) An analysis of the trade receivables is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HK$'000</td>
<td>HK$'000</td>
</tr>
<tr>
<td>Within 60 days</td>
<td>533,253</td>
<td>585,004</td>
</tr>
<tr>
<td>Between 61 days to 180 days</td>
<td>395,030</td>
<td>206,082</td>
</tr>
<tr>
<td>Over 180 days</td>
<td>8,087</td>
<td>26,040</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>936,370</strong></td>
<td><strong>817,126</strong></td>
</tr>
</tbody>
</table>

Industry data:

EMM normally grants 60 days credit to its customers.

(iii) EMM's consolidated income statement for the year ended 31 December 2006 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>HK$'000</td>
<td>HK$'000</td>
</tr>
<tr>
<td>Revenue</td>
<td>3,044,505</td>
<td>2,832,638</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(2,722,517)</td>
<td>(2,487,302)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>321,988</td>
<td>345,336</td>
</tr>
<tr>
<td>Other revenue</td>
<td>9,111</td>
<td>11,098</td>
</tr>
<tr>
<td>Other operating gains (net of losses)</td>
<td>2,898</td>
<td>10,423</td>
</tr>
<tr>
<td>Distribution and selling expenses</td>
<td>(11,605)</td>
<td>(5,837)</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>(79,849)</td>
<td>(80,222)</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>(2,724)</td>
<td>(12,695)</td>
</tr>
<tr>
<td>Profit from operations</td>
<td>239,819</td>
<td>268,103</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(73,970)</td>
<td>(31,484)</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>165,849</td>
<td>236,619</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>(27,273)</td>
<td>(41,300)</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td><strong>138,576</strong></td>
<td><strong>195,319</strong></td>
</tr>
</tbody>
</table>
Question 1  22 minutes
(a) Determine XYZ & Co's ethical obligations in relation to the change in auditors. (6 marks)
(b) Identify issues or conditions surrounding this potential engagement that your firm would consider as indicating a higher risk of material misstatement at the financial statement level. (6 marks)

Question 2  18 minutes
Your firm has accepted the engagement and you have been appointed as the manager-in-charge of the EMM audit.
(a) Perform analytical procedures to obtain an understanding and, where appropriate, assess the risks of material misstatement at the assertion level of EMM's trade receivables. (6 marks)
(b) Suggest four possible causes for further analysis or inquiry after you have performed the above analytical procedures. (4 marks)

Question 3  27 minutes
You assessed the risk of material misstatement of the existence of EMM's cash and cash equivalents as medium, with an expectation that EMM's internal controls operated effectively during the period.
(a) Determine the audit approach you would adopt to examine the existence of EMM's cash and cash equivalents. (3 marks)
(b) List two control activities and two monitoring of controls relevant to the existence of EMM's cash and bank balances that you would expect to have been implemented. (4 marks)
(c) For each of the control activities and monitoring of controls you mentioned in (b), suggest an appropriate test of control. (4 marks)
(d) Determine any substantive procedures you would perform to examine the existence of EMM's cash and cash equivalents. (4 marks)

Question 4  23 minutes
A few days before EMM's directors approved the financial statements for the year ended 31 December 2006, your team's enquiries identified the fact that the general manager of one of the subsidiaries in EMM had misappropriated cash of HK$ 30 million.
Determine implications to your audit and the actions your team would take in response to this situation. (13 marks)

(Total = 50 marks)
HKICPA May 2007 (amended)
CASE STUDY 5

You are the audit manager of a Hong Kong CPA firm, Xing, Yang, Zue and Co (‘XYZ’). Your firm has recently been engaged as the auditor of ABC Jewellery Limited (‘ABC’) and is currently in charge of the audit of ABC for the year ended 31 December 2005. ABC, a company incorporated in Hong Kong, engages in the manufacturing and trading of a wide range of jewellery. ABC products are mainly sold to local customers and tourists in Hong Kong.

During the planning stage of the audit, the following information has come to your attention:

(1) ABC was established 3 decades ago by Mr King, a gentleman who was highly respected in the jewellery business and internationally renowned for his jewellery designs and gem valuation expertise. Mr King is ABC's chairman and managing director and holds 80% of its issued share capital. The remaining 20% shareholding is held equally by Mr King's two daughters and two key employees.

(2) ABC was previously audited by another CPA firm run by a sole proprietor, who died in a car accident last year. Your firm was then appointed as the auditor of ABC, upon an introduction by Mr King's son-in-law, who is currently the administration manager of your firm. Prior to this engagement, your firm had never been involved in any assurance engagement in the jewellery industry.

(3) Clean audit reports had been issued by ABC's previous auditor throughout the past 3 decades.

(4) With the economic recovery, there has been a sharp increase in ABC's revenue for the year under review. To cope with such an increase in demand, two new shops, one located in Kowloon and another in Macau, were opened during the year in addition to the main shop in Hong Kong. All the jewellery manufacturing processes were carried out at the mezzanine and upper two floors of the main shop.

(5) ABC's revenue and profit before tax for the year under review amounted to approximately HK$ 139 millions and HK$ 23 millions respectively. ABC's inventory as at the year end date amounted to approximately HK$ 98 millions, out of which un-mounted gems (ie raw materials) accounted for approximately 38% of the total inventory value. The value of work in progress was negligible as at the year end.

(6) Mr King was primarily responsible for the purchase of gems and design of jewellery in ABC. He purchased gems from various sources. Apart from the normal sources of known suppliers, Mr King also purchased gems from various street stalls in South East Asian countries.

(7) Usually about 80% (in value) of the gems purchased were from known suppliers. However, Mr King would travel around various South East Asian countries and shop around the gem markets there. When he found some good gems in a street stall, he would offer to purchase all the gems from the seller with a lump sum payment of cash disguising his real intention and keeping the price down. After a successful purchase, he would pick out and hold a few gems which he considered to be of good value, and get rid of the rest either by using them for lower grade jewellery or by giving them to children of his employees and friends.

(8) Official invoices and receipts for gems purchased from known suppliers were available for inspection. However, only hand written cash sales memos on scrap paper were available for gems purchased from various street stalls in South East Asian countries. Mr King would also jot down brief notes as to the cost of individual gems in a private notebook. In cases where two or more gems were bought up by Mr King in a single purchase, the allocation of cost to individual gems would be made according to his judgement.
All high value gems were kept by Mr King in his private safe in the main shop. When certain gems were needed for a particular design, Mr King would take his gem collections out and pick the appropriate pieces. He would then decide the cost allocation of the designed jewellery.

Each finished item had an individual sale value according to a number of determining factors such as size, shape, weight, type, colour, clarity, cut, and craftsmanship. Some gems, such as South African diamonds, Russian diamonds, emeralds and green jades, differed substantially in sale value, but were not easily distinguishable by a layman.

**Required**

**Question 1**

(a) Determine your firm’s ethical obligations in relation to the change in auditors. (4 marks)

(b) Comment on the potential independence/competency issues surrounding the new audit engagement of ABC and the circumstances under which professional standards have to be considered. (6 marks)

(c) Explain the effects of the opening balances of ABC’s financial statements at 1 January 2005 on the work of your team, and determine the procedures your team would perform on these opening balances. (8 marks)

(d) Identify and discuss the factors or issues that you would consider when you assess the risk of material misstatement at financial statement level. (7 marks)

**Question 2**

Regarding the audit for ABC’s inventory balance:

(a) Assess the risk of material misstatement of the valuation and allocation assertion of ABC’s inventory balance as at 31 December 2005. You should identify and discuss the specific issues you have considered. (7 marks)

(b) Determine the audit procedures you would perform in response to the assessed risk of material misstatement of the valuation and allocation assertion of ABC’s inventory as at 31 December 2005. (8 marks)

(c) Assess the risk of material misstatement of the existence assertion of ABC’s inventory balance as at 31 December 2005. You should identify and discuss the specific issues you have considered. (5 marks)

(d) Determine the audit procedures you would perform in response to the assessed risk of material misstatement of the existence assertion of ABC’s inventory as at 31 December 2005. (5 marks)

(Total = 50 marks)

HKICPA September 2006 (amended)
CASE STUDY 6

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 2005. 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 2005 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 counting results are adjusted to the results of the physical counting.

(3) A full physical inventory count was conducted at the reporting date. Inventory with a book value of approximately HK$ 900,000 was written off as a result of this exercise. Members of your audit team observed the full physical inventory count at the reporting date and reported that it was properly conducted. However, upon further enquiry, 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 count. 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 2005 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 reporting date. As an alternative test, your audit assistant circularised trade debtors and trade creditors that showed significant balances in the ledger at the reporting date, and reviewed the board minutes after the year-end. The response rates for both the trade debtors and the trade creditors circularisation tests were considered to be satisfactory, and your assistant reported that no material discrepancy was found from the confirmation procedures.
(6) Since March 2005, ABC has been exploring the Mainland market by despatching 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

**Question 1**

67 minutes

(a) (i) 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 (ie low, medium, or high); and (10 marks)

(ii) Determine the appropriate responses to the assessed risk in (i). (5 marks)

(b) Evaluate the effectiveness of your assistant's alternative procedures (ie the confirmation procedures for trade debtor and creditor balances) for sales and purchases cut-offs. Suggest improvements to the confirmation procedures to enhance their effectiveness. (8 marks)

(c) (i) Determine the possible causes of the write-off of HK$900,000 of ABC's inventory and the assertion(s) affected by it; and (4 marks)

(ii) Based on your view of the cause of the write-off, determine the applicable auditing standard(s) regarding the write-off and therefore the audit work your team would perform. (10 marks)

**Question 2**

23 minutes

Regarding the consignment sales of ABC:

(a) Identify the major audit issues in ABC's consignment sales recognition for the purpose of assessing the risk of material misstatement at the assertion level. (6 marks)

(b) Describe the procedures (including risk assessment and further audit procedures) you would perform in relation to the consignment sales. (7 marks)

(Total = 50 marks)

HKICPA February 2006 (amended)
Business Assurance
Question bank - answers
CASE STUDY 1 (May 2009)

Answer 1

(i) Before accepting the audit engagement, the engagement team/partner should be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and specific audit engagements have been followed, and that conclusions reached in this regard are appropriate and have been documented. In general, such procedures include considering:

(1) the integrity of HKM and whether there is any information that would lead the engagement team to conclude that HKM lacks integrity;
(2) whether the engagement team is competent to perform the audit engagement and has the necessary time and resources; and
(3) whether XYZ & Co and the engagement team can comply with other ethical requirements, such as independence.

(ii) During the engagement performance, the engagement partner should take responsibility for the direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements, and for the auditor's report that is issued to be appropriate in the circumstances.

The engagement partner should review the audit documentation and discuss it with the engagement team to satisfy himself/herself that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

The engagement partner should also satisfy himself/herself that members of the engagement team have undertaken appropriate consultations for any difficult or contentious issues arising during the course of the engagement.

If differences of opinion arise (which may be within the engagement team, between the engagement team and those consulted, or between the engagement partner and the engagement quality control reviewer) the engagement team should follow the firm's policies and procedures for dealing with and resolving differences of opinion.

(iii) Since HKM is a listed company, the engagement partner should ensure that an appropriate engagement quality control reviewer has been appointed.

The engagement partner should discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer.

XYZ & Co should not issue the auditor's report until the completion of the engagement quality control review.

Answer 2

(a) An increase in audit materiality increases the total error that the auditor is willing to accept.

Therefore, at a given level of assessed risk, an increase in the audit materiality level in the revenue of HKM will reduce the sample size for the tests of details.

At a given level of audit materiality, a reduction in the auditor's assessment of the risk of material misstatement will reduce the sample size.

Provided that the engagement team is satisfied that assessed risks of the relevant assertions of revenue were low, for example by performing appropriate tests of controls to obtain evidence of the operating effectiveness of the controls during the period, the extent of tests of details, ie the sample size, could be kept to a minimum.
Occurrence of the sales transactions refers to the assertion that all sale transactions recognised by HKM during the year represent transactions that had actually occurred and pertained to HKM.

The fact that documents are missing indicates that there may be weaknesses in HKM's internal controls, particularly if these were not identified by HKM's own system but by the engagement team.

This, however, does not necessarily indicate that the transaction had not occurred or did not pertain to HKM.

The engagement team should perform other audit procedures to verify the occurrence of this particular transaction, for example, by inspection of any documentary evidence of inventory movements for the transactions and subsequent settlement of the receivables arising.

Where necessary, the engagement team may ask the customer to confirm this particular sale transaction.

Unless the engagement team fails to obtain evidence of the occurrence of the transactions by these means, the sample item should not be classified as an error for the purpose of the tests of details.

The engagement team should however reconsider whether the assessed risks of material misstatement remain valid in view of the fact that HKM's internal controls have failed to locate the missing documents.

If the engagement team perform tests of details concurrently with tests of control, the engagement team may need to increase the extent of tests of control to obtain evidence that the assessed risk of material misstatement can be maintained as low.

If the engagement team fails to satisfy themselves that the assessed low risk of material misstatement can be maintained, the engagement team should revise the nature and timing of tests of details.

Answer 3

(a) In accordance with HKSA 610, when intending to use the work of HKM's internal auditors, the engagement team should evaluate its adequacy for the external audit's purposes by considering whether:

(1) The work is performed by persons having adequate technical training and proficiency as internal auditors, and the work of assistants is properly supervised, reviewed and documented;

(2) Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;

(3) Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and

(4) Any exceptions or unusual matters disclosed by internal auditing are properly resolved.

(b) Physical inspection of property, plant and equipment ('PPE') provides evidence of the existence (but not ownership or value) of the PPE.

With respect to the year-end physical inspection of PPE, it would be time-consuming and costly for the engagement team to inspect all PPE. Consequently, PPE is a key area in which the engagement team would like to rely on the work of HKM's internal auditors.

This would require the engagement team to review and appraise the internal audit work programme prior to the physical inspection of PPE and review their work afterwards.
The engagement team would still need to inspect all material PPE items.  
[marks will be awarded for other valid points.]

Key internal controls for the completeness of merchandise acquisition from suppliers are likely to include pre-numbering and accounting for the sequence of purchase orders, goods received notes and vouchers.

The work of HKM's internal auditors is likely to relate to performing regular sequence checks on a sequence of the pre-numbered purchase orders, goods received notes and vouchers.

Since it is likely that a large number of acquisition transactions will be involved, this internal auditors' work will be of interest to the external auditors. The engagement team will rely on the work of HKM's internal auditors.

Before relying on HKM's internal auditors, the engagement team will review and appraise the internal audit work programme for the sequence check of purchase orders, goods received notes and vouchers, and review their work afterwards.  
[marks will be awarded for other valid points.]

**Answer 4**

The provision for losses from a lawsuit is a kind of accounting estimate. In accordance with HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, XYZ & Co should adopt one or a combination of the following three approaches in the audit of the HK$4,305,200 provision:

(a) Review subsequent events which provide audit evidence of the reasonableness of the estimate made;
(b) Review and test the process used by HKM's management to develop the estimate;
(c) Test the controls over how management made the estimate, together with appropriate substantive procedures; or
(d) Use an independent estimate for comparison with that prepared by HKM's management.

*Testing the Controls over how the Estimate was made*

XYZ and Co should test the operating effectiveness of the controls operating over how HKM's management made their estimate of the provision required.

*Reviewing and Testing the Process Used by Management*

The amount of provision is not a rounded figure suggesting that the management has adopted a detailed process in deriving the estimate.

XYZ & Co should evaluate the data and assumptions on which the estimate is based for reasonableness and sensitivity, such as:

- recent court cases;
- life expectancy of the injured;
- expected inflation rates;
- expected interest rates; and
- expected employment prospects.

If applicable, XYZ & Co would seek direct communication with HKM's lawyers.

XYZ & Co should also test the calculations of this provision. The nature, timing and extent of the tests will depend on the assessed risk of material misstatement, the complexity of calculation, XYZ & Co's understanding and evaluation of the procedures and methods used by HKM, and the materiality of the estimate.
XYZ & Co should consider the procedures for management's approval of the provision for reasonableness. XYZ & Co would consider whether review and approval are performed by the appropriate level of management and that this is evidenced in the documentation supporting the determination of the accounting estimate.

Review of Subsequent Events
Transactions and events which occur after year end, but prior to completion of the audit, may provide audit evidence regarding the provision made by HKM's management.

It is usual to negotiate a settlement before legal proceedings or trial. If a settlement is reached after the year end, XYZ & Co may not need to review and perform any audit procedures other than comparing the terms of settlement to the provision.

Use of an Independent Estimate
XYZ & Co may make or obtain an independent estimate for the quantum of potential losses (such as independent legal or forensic advice in assessing the strength of the case and the quantum of compensation) and compare it with the provision prepared by HKM's management.

It may also be appropriate to compare provisions and other accounting estimates made for prior periods with the history of compensation payments and the actual results of those periods.

CASE STUDY 2 (September 2008)

Answer 1
(a) Gold and Silver should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements in accordance with HKSQC 1 *Quality controls for firms that perform audits and reviews of financial statements, and other assurance and related services engagements.*

Gold and Silver should also ensure that appropriate procedures regarding the acceptance of the new client relationships are being followed and that conclusions are appropriate and documented, in accordance with HKSA 220 "Quality control for an audit of financial statements".

Under the circumstances of the question, Ms Or (and/or Gold and Silver) should consider the following matters:

- The integrity of Ms Au;
- The integrity of other principal shareholders, key management and those charged with governance (and the extent of influences by Ms Au on them);
- Whether the engagement team is competent to perform the audit engagement of business in decorative lightings industry;
- Whether the engagement team has the necessary time and resources (in particular Gold and Silver is short of manpower); and
- Whether Gold and Silver and the engagement team can comply with ethical requirements.

The engagement team should obtain such information as it considers necessary in the circumstances before accepting an engagement by ZZZ as a new client. Where issues have been identified and Gold and Silver has decided to accept the client relationship with ZZZ (in particular, the audit of its financial statements for the year ended 31 December 2008), Gold and Silver should document how the issues are resolved.
(b) Ms Or should consider the business reputation of Ms Au, the key management, related parties and those charged with ZZZ’s governance. The question has no information indicating that Ms Au or the management of ZZZ is ignorant of the principles of corporate governance or the duties of directors.

Ms Or should consider the nature of ZZZ’s operations, eg whether or not ZZZ has been engaged in speculative activities and/or accepting unusually high business risks. Accepting unusually high business risks may suggest that the management is not acting in the best interest of ZZZ.

Ms Or should consider whether or not ZZZ has been engaging in complex transactions or aggressive deals that make the determination of the effects on the financial statements unnecessarily highly subjective. Unless it is a business norm, unnecessarily complex transactions or aggressive deals may suggest that the management is not acting in the best interest of ZZZ.

Ms Or should assess Ms Au’s attitude towards matters such as aggressive interpretation of accounting standards and/or the internal control environment, such as whether or not Ms Au has exercised her power to override internal controls unnecessarily.

Ms Or should find out whether or not the reasons for the non-appointment of Red and Blue related to the integrity of ZZZ.

Ms Or should check whether or not Ms Au displays a positive attitude towards compliance with regulatory or contractual obligations.

Ms Or should check for any indication of money laundering and/or other criminal activities by Ms Au (or ZZZ).

(c) Under the Code of Ethics for Professional Accountants (‘Code’) Section 440 ‘Changes in a Professional Appointment’, Gold and Silver should find out whether the change of auditor has been properly dealt with in accordance with the Companies Ordinance or other legislations/regulations.

If the change of auditor has not been properly dealt with, Gold and Silver should not accept the invitation.

Gold and Silver should also request ZZZ’s permission to communicate with Red and Blue.

Gold and Silver should not accept the invitation without first communicating in writing with Red and Blue to enquire whether there is any reason for or circumstance behind the proposed change of which they should be aware when deciding whether or not to accept nomination.

Section 440 of the Code requires Gold and Silver, with ZZZ’s permission, to write to Red and Blue asking if there are any unusual circumstances surrounding the proposed change which Gold and Silver should be aware of, so that Gold and Silver may determine whether or not to accept the nomination.

Since ZZZ is a listed company, the change in auditor is also governed by Section 441 of the Code ‘Change of Auditors of a Listed Issuer of The Stock Exchange of Hong Kong’.

In accordance with Section 441 of the Code, Gold and Silver should request a copy of the letter of resignation and any correspondence referred to in the letter directly from ZZZ for consideration in addition to the professional clearance from Red and Blue before accepting the appointment.

If ZZZ refuses to provide Gold and Silver with a copy of the letter of resignation and any correspondence referred to in the letter of resignation, Gold and Silver should decline the appointment.
Answer 2

(a) The existence assertion of inventories refers to whether or not the carrying amount of inventories on ZZZ's statement of financial position exists as at 31 December 2008.

The risk of misstatement of the existence of ZZZ's inventory balance as at 31 December 2008 appears medium to high because:

- ZZZ's inventories consist of various types of lighting products with different carrying amounts, and their appearance may not be readily distinguishable to laypersons so as to establish their makes or types (unless the stocktaking team is made up of lighting experts).
- Many components of lighting products are highly desirable and movable, ie the susceptibility of assets to loss or misappropriation is high.
- Many components of lighting products are vulnerable to theft, and fraudulent schemes may be used to disguise the unaccounted portion of inventories.
- ZZZ's inventories are kept in four factories in Mainland China, and there may be goods in transit during the inventory counting. Therefore, there are risks of duplication or omission.
- It can be difficult to determine the existence of work-in-progress (ie stage of completion).

(b) ZZZ's inventories at 31 December 2008 are likely to be material because the carrying amount as at 31 August 2007 (HK$340,501,000) represents approximately:

- 472.9% of net profit for the eight months ended 31 August 2008
- 477.1% of net profit for 2007
- 37.8% of current assets at 31 August 2008
- 43.0% of net assets at 31 August 2008
- 21.4% of total assets at 31 August 2008

As the inventory is material and in accordance with HKSA 501 Audit Evidence: Specific Considerations for Selected Items, Gold and Silver should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at the physical stocktaking.

During attendance at ZZZ's physical stocktake, Gold and Silver should review the stocktake instructions from ZZZ, observe the counting procedures and perform test counts.

Gold and Silver should assess the independence and competence of ZZZ's counting team and whether the team is appropriately briefed and supervised.

When performing the test counts, Gold and Silver should trace items selected from the records to the physical inventory for overstatement (existence). Gold and Silver should also trace items selected from the physical inventory to the count records for understatement (completeness).

Gold and Silver should perform cut-off procedures on the details of the movement of inventory just prior to, during and after the count.

Gold and Silver should consider the needs to obtain expert confirmation about the nature and specification of some lighting products (due to the wide range and varieties of models and specifications).

As there are four locations in Mainland China, Gold and Silver needs to consider at which locations attendance is appropriate, taking into account the materiality of inventory and the risk of material misstatement at different locations.
For practical reasons, the physical inventory count may be conducted at a date other than period end. Gold and Silver would determine whether, through the performance of appropriate audit procedures, changes in inventory between the count date and the period end are correctly recorded.

When inventory is under the custody and control of a third party, Gold and Silver should obtain direct confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity or perform a physical count directly in the third party’s custody if the risk is high.

Gold and Silver should consider the procedures of recording the stocktake results onto the financial statements.

(c) The carrying amount of ZZZ's inventories at 31 December 2007 is regarded as the ‘opening balance’ of inventories in the upcoming audit of financial statements for 2008.

Opening balances are based on the closing balances of the prior period, ie balances at 31 December 2007, and reflect the effects of (1) transactions of prior periods; and (2) accounting policies applied in the prior periods.

A material misstatement in the opening balance of ZZZ’s inventories (if not properly restated) could have a consequential effect on the profit or loss for 2008. Any misstatements in the inventories at 31 December 2007 could materially affect the financial statements for 2008.

In accordance with HKSA 510 Initial Audit Engagements – Opening Balances, Ms Or (Gold and Silver) should obtain sufficient appropriate evidence that:

- The opening balances do not contain misstatements that materially affect ZZZ’s financial statements for 2008;
- The prior year’s closing balances have been correctly brought forward to 2008 or, when appropriate, have been restated; and
- Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed.

As an initial audit engagement it would be impossible, so Gold and Silver is not required to perform a physical count on the beginning balance of inventories. According to the paragraph A4 of HKSA 510 Initial audit engagements – opening balances, when the prior period’s financial statements were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by reviewing the predecessor auditor’s working papers. In these circumstances, the current auditor would also consider the professional competence and independence of the predecessor auditor.

**Answer 3**

Impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, according to HKAS 36 Impairment of Assets. The recoverable amount of receivables is the present value of estimated future cash flow, discounted at the effective interest rate.

As some of ZZZ’s customers may not settle their debts fully, Ms Or may explain to Ms Au that the recoverable amount of ZZZ’s accounts receivable can be lower than the carrying amount (which presumably is the invoiced amount) totalling HK$ 287,094,000 at 31 August 2008 (HK$ 197,290,000 at 31 December 2007). Accordingly, impairment of receivables reflects an allowance to reduce accounts receivable to their recoverable amount.
Ms Or may explain to Ms Au that impairment of receivables is a kind of accounting estimate in the absence of a precise means of measurement, and that there are at least three bases in calculating the impairment of receivables:

- As a consistent proportion of total receivables;
- As a consistent proportion of sales; and
- As a progressive proportion according to the ageing of respective receivable balances.

In addition, it is often the case that the management would assess the impairment of receivables on individual basis.

Based on the reported figures on the financial statements and management accounts, Ms Or may explain to Ms Au that, at 31 August 2008, the impairment of receivables of ZZZ stays at the same level as 31 December 2007 at HK$ 2 million, indicating a sign of inadequacy in the context of the relevant financials as follows:

- 0.70% of receivables at 31 August 2008 (1% at 31 December 2007)
- 0.29% of sales for January 2008 to August 2008 (0.25% of total sales for 2007)
- 0.19% of projected total sales (HK$ 1,050,688,500) for 2008

Ms Or may draw Ms Au's attention to the age profiles of the accounts receivable which have become more slow moving from December 2007 to August 2008. This suggests that the 'quality' of the accounts receivable appear to have declined. In addition, ZZZ's revenue has increased significantly during 2008.

Furthermore, based on the monthly analysis of ZZZ's sales, the receivables turnover days has increased to 3+ months for the period from January 2008 to August 2008, while the receivables turnover for 2007 was almost exactly 3 months. This indicates that on average ZZZ's customers have taken a longer period of time to settle their debts. ZZZ may face the risk of overtrading resulting in undue pressure on its cash and working capital.

Ms Au and the management of ZZZ are responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainties regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment. Impairment of receivables may be determined as part of the routine information system relevant to financial reporting operating on a continuing basis, or as a non-routine function operating only at the year end.

**Answer 4**

(a) As per HKSRE 2410, the objective of a review of interim financial report is to enable the auditor to express a conclusion whether anything has come to his attention that causes him to believe that the interim financial report is not prepared, in all material respects, in accordance with HKAS 34 "Interim Financial Reporting".

A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial report is free from material misstatement. A review provides limited assurance.

A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures.

A review may bring significant matters affecting the interim financial report to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

(b) Gold and Silver should perform the review of ZZZ's interim financial report in accordance with HKSRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity.

With respect to the other information that accompanies the interim financial report of ZZZ, Gold and Silver should read it to consider whether any such information is materially inconsistent with the interim financial report.
If Gold and Silver identifies a material inconsistency, Gold and Silver should consider whether the interim financial report or the other information needs to be amended.

If Gold and Silver believes that a material adjustment should be made to the interim financial information for it to be prepared, in all material respects, in accordance with HKAS 34, and management of ZZZ refuses to make the amendment, Gold and Silver should express a qualified conclusion when the effect of the amendment is material but not pervasive or an adverse conclusion when the effect of the amendment is material or pervasive.

If an amendment is necessary in the other information and management of ZZZ refuses to make the amendment, Gold and Silver should consider including in the review report an additional paragraph describing the material inconsistency, or taking other actions, such as withholding the issuance of the review report or withdrawing from the engagement.

If the other information of ZZZ appears to include a material misstatement of fact, Gold and Silver should discuss the matter with ZZZ's management to determine whether valid differences of judgment or opinion exist and whether to request ZZZ's management to consult with a qualified third party to resolve the apparent misstatement of fact.

If an amendment is necessary to correct a material misstatement of fact and ZZZ's management refuses to make the amendment, Gold and Silver should consider taking further action as appropriate, such as notifying the audit committee of ZZZ and obtaining legal advice.

CASE STUDY 3 (February 2008)

Answer 1

(a) The engagement team/partner should consider:

(1) whether the engagement team is competent to perform the audit engagement and has the necessary time and resources; and

(2) whether XYZ & Co and the engagement team can comply with other ethical requirements, such as independence.

Given that XYZ has been the auditor of HKP since its incorporation, XYZ & Co need not revise its previous assessment of the integrity of the principal owners, key management and directors, unless there have been significant changes in principal shareholders, key management or directors, or XYZ & Co has obtained new information indicating that the integrity of these persons are in doubt.

Given that XYZ has been the auditor of HKP since its incorporation, and given that the operations of HKP have not changed significantly during the last year, there is no indication that the firm or the engagement team would not be competent to perform the audit.

Provided that the firm and all members of the engagement team satisfy the independence requirements of the Code of Ethics for Professional Accountants (the Code), there is no indication that XYZ should not accept the 2007 audit engagement of HKP.

In particular, the engagement team should assess the possible familiarity threat to compliance with the Code since the manager-in-charge of HKP's audit has not changed for the last five years.

If the familiarity threat is considered significant, the safeguard of rotation of the manager-in-charge (or even partner-in-charge) should be implemented.
(b) The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

In general, no particular response is required for a low assessed risk of material misstatement at the financial statement level, except that the engagement team should continue to maintain professional scepticism in gathering and evaluating audit evidence.

However, HKSA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements recognises that management is in a unique position to perpetrate fraud because of management’s ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Therefore, even if the engagement team assessed the risk of material misstatement at the financial statement level due to fraud as low, the engagement team is required to perform audit procedures to respond to the (presumed) risk of management override of controls.

These audit procedures may include:

1. the analytical review of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements to determine whether they are appropriate;
2. the analytical review of accounting estimates for biases that could result in material misstatement due to fraud; and
3. making enquiries of HKP’s management to obtain an understanding of the business rationale for significant transactions, if any, that are outside of HKP’s normal course of business or that otherwise appear to be unusual.

Answer 2

(a) Classification of the bank loans refers to the assertion that information about the loans is appropriately presented and described.

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 circumstances in HKP’s particular case are more complicated because they involve the uncommon case of breaches of covenants and waivers from banks subsequent to the reporting date.

Correct classification of the bank loans depends on whether there is relevant guidance in the financial reporting standards for such cases, correct interpretation of such guidance, if there is any, and appropriate application of the guidance to this particular case.

The risk of material mis-classification of the bank loans as current or non-current is assessed as high (or medium at least).

(b) Under the usual circumstance where no new loans were raised or refinanced during the year, the audit team may perform a minimal level of substantive procedures, such as analytical procedures and obtaining confirmation from the banks.

However, given the non-routine nature of this case, and given that a proper classification of the loans would involve a high level of technical competence in interpreting the relevant financial reporting, which is likely to involve professional judgement, a substantive approach would be more appropriate.

The appropriate substantive procedures would include:
(1) inspecting the loan agreements to determine the effects of the breaches of the covenants, including effects on HKP’s obligations to repay the principal amounts;

(2) asking the management for their reasoning in classifying the loans as current after the breaches, and assessing the validity of their treatment in accordance with relevant financial reporting standards;

(3) obtaining confirmation from the banks that they have granted waivers to HKP, and reviewing the terms of the waivers to determine whether the waivers would, in accordance with the requirements of the relevant financial reporting standards, permit HKP to classify the loans as non-current;

(4) re-calculating the apportionment of the amount between current and non-current in accordance with the requirements of relevant financial reporting standards after considering the effects of the waivers obtained from the banks;

(5) reviewing the final draft of the consolidated financial statements to check that the bank loans are presented in the appropriate classes of assets and properly disclosed.

(c) In accordance with HKSA 220, the engagement team would undertake appropriate consultation on difficult or contentious matters.

The engagement partner should be satisfied that members of the engagement team have undertaken appropriate consultation on the matter, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as the technical partner or a panel of partners.

The engagement partner should ensure that the nature and scope of, and conclusions resulting from, such consultations are documented and agreed with the party consulted; and that the conclusions resulting from the consultations have been implemented.

Since HKP is a listed company, the engagement partner should appoint a quality control reviewer to evaluate the significant judgements made by the engagement team, including the judgement in this case on the classification of the bank loans.

The engagement partner should not issue an auditor’s report until the quality review is completed.

**Answer 3**

(a) Completeness of trade and other payables refers to the assertion that all liabilities in trade and other payables that should have been recorded have been recorded.

Under usual circumstances, the inherent risks of material misstatement in completeness (ie understating) of trade and other payables would be assessed as normal/medium and the auditor may expect the entity’s internal controls to reduce the combined (inherent risk and control risk) risk of material misstatement to low.

Although HKP had experienced severe cash flow problems during the year ended 31 December 2007, there is no indication that the risk of material misstatement in completeness of trade and other payables is particularly high.

Therefore, unless the engagement team suspects fraudulent reporting, which is not apparent from the information given, the engagement team may continue to assess the risk of material misstatement of all the assertions of HKP’s trade and other payables as low, with the expectation that HKP’s controls over trade and other payables are operating effectively.

[Candidates may draw other conclusions, provided that they can justify them.]
(b) Given that tests of controls have been performed in the last year and that there is no material difference in the assessed level of risk of misstatement, it would be most efficient for the engagement team to adopt a combined approach for the completeness of trade and other payables in this case.

The engagement team may use audit evidence about the operating effectiveness of the controls over the completeness of trade and other payables XYZ & Co obtained in last year's audit.

In this case, the engagement team should ask the management of HKP whether there have been any changes in the controls.

The engagement team should observe the operation of the controls or inspect documentary evidence to confirm the understanding of any such changes or absence of changes.

The engagement team should perform tests of control on those changes during the year.

For those controls that have not changed during the year, the engagement team may significantly reduce the extent of tests of controls since satisfactory tests of controls were performed in the previous year's audit.

Substantive procedures to perform in the current year may include:

1. substantive analytical procedures, such as comparing inventory turnover and/or the aging of trade payables with standard credit terms granted by suppliers/payables turnover;
2. asking the management to notify any changes in major suppliers and inspecting documentary evidence for management's representations/consistency with records;
3. re-calculating the casting of trade and other payables to ensure all ledger balances of trade and other payables have been included;
4. re-performing reconciliations of suppliers' statement to ledger balances.

Answer 4

(a) When the bank loans are reclassified as current, HKP will report a net current liability of HK$176,129,000 [HK$198,261,000 – HK$140,270,000 – HK$234,120,000].

A net current liability is an example of events or conditions which may give rise to business risks that individually or collectively may cast significant doubt about the going concern assumption as set out below.

HKP's inability to comply with the terms of bank loan agreements is another indicator or going concern issue.

While there are material uncertainties relating to the event or condition that may cast significant doubt on HKP's ability to continue as a going concern, it may not be appropriate to conclude that HKP should not use the going concern assumption when preparing the financial statements.

Under the going concern assumption, HKP is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations.

Given that HKP had no intention to cease business and the banks had formally waived HKP's non-compliance with the loan agreements, there is no strong argument that HKP should not adopt the fundamental principle of assumption as a going concern in the preparation of financial statements.
(b) If the engagement partner is satisfied that adequate disclosure about the going concern issue is made in the financial statements, the engagement partner need not qualify the audit opinion.

However, the engagement partner should modify the auditor's report by adding an emphasis of matter paragraph that highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on HKP's ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matters.

The emphasis of matter may read as follows:

"Without qualifying our opinion, we draw attention to Note 1(c) in the financial statements which indicates that the Group incurred a net loss after tax of HK$23,151,000 during the year ended 31 December 2007 and, as of that date, the Group's current liabilities exceeded its current assets by HK$176,129,000 because bank loans of HK$234,120,000 have been classified as current liabilities as a result of breaches of covenants during the year. These conditions indicate the existence of a material uncertainty which may cast significant doubt about the Group's ability to continue as a going concern."

[Candidates may opine that an unqualified opinion be issued, but they have to justify their position.]

CASE STUDY 4 (May 2007)

Answer 1

(a) 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 familiar threat to independence, and that EMM did not accept the increase in audit fee.

If EMM are Hong Kong incorporated listed issuers, section 140A(2) of the Companies Ordinance requires an auditor who resigns from office before the expiry of his term must, if the resignation is to be effective, 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.

(b) Risks of material misstatement at the financial statement level relate more pervasively to the financial statements as a whole and potentially affect many assertions.

These risks may be derived in particular from a weak control environment. In addition to a weak control environment, other conditions, such as (1) aggressive business strategies, (2) significant business risks arising from changes or complexity of business operations, or (3) unusually high pressures on performance measures and review.

The following facts may indicate a higher risk of material misstatement at the financial statement level:

1) The integrity of the directors/management of EMM may be questionable since the reasons for change in auditors provided by XYZ & Co are different from those provided by the directors/management of EMM;

2) The plan to double the group's revenues within five years may be too aggressive;

3) The company has raised debt finance at a comparatively high interest rate of 9.5% per annum, indicating that the company is in 'desperate' need of external funding to finance its aggressive expansion plan;

4) The company is listed on the Hong Kong Stock Exchange and an overseas stock exchange. The company is subject to greater pressure in its performance measures and review.

Answer 2

(a) In performing analytical procedures such as risk assessment procedures, the auditor develops expectations about plausible relationships that are reasonably expected to exist in accordance with HKSA 315.

EMM are expanding. As a result, comparisons of current year data with prior-year data will show significant changes. The auditor, ABC & Co, has two important means of developing expectations about the financial statements. First, ABC & Co can obtain industry information on comparable companies and ABC & Co might also expect trends evidenced in prior audits to continue.

ABC & Co then perform the following calculations:

Revenue/Receivables – 2006: 3.25 times (2005: 3.47 times); OR Receivable Turnover days- 2006: 112 days (2005: 105 days) OR calculations of changes in sales vs. changes in trade receivables OR other reasonable calculations.

Aging of trade receivables – 2006: 57% within 60 days (2005: 72% within 60 days) OR other reasonable calculations.
Summary presentation as follows:

<table>
<thead>
<tr>
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<th>2006</th>
<th>2005</th>
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<tbody>
<tr>
<td>Revenue/receivables</td>
<td>3.25 times</td>
<td>3.47 times</td>
</tr>
<tr>
<td>Receivable turnover days</td>
<td>112 days</td>
<td>105 days</td>
</tr>
</tbody>
</table>

Aging details

- Within 60 days: 57% (2006) vs. 72% (2005)
- Between 61 days to 180 days: 42% (2006) vs. 25% (2005)
- Over 180 days: 1% (2006) vs. 3% (2005)

Revenue/receivables [or receivable turnover days] is a measure of whether a sound credit policy has been implemented. EMM's collection periods for the current year and the last year are longer than industry average. EMM's collection periods for both years are also beyond its normal credit period. The analysis may indicate an audit problem related to the uncollectibility of certain receivables (i.e., the valuation assertion).

Further breakdown shows an increase in receivable balances that exceed the normal credit period. This analysis may also indicate there may be inadequate allowance for uncollectible amounts (i.e., the valuation assertion).

A high level of the turnover days, together with pressure to report growth in revenues, might indicate higher risk of fraud in creating fictitious credit sales in the current period. The occurrence of sales during the year and hence the existence of trade receivables at the reporting date, would have a higher risk of misstatement.

(b) After the analysis, ABC & Co needs to collect further information to verify the cause of the unexpected results such as:

1. Changes in accounting practice and policy, for instance, the inclusion of debit balances on the creditors' ledger as receivables instead of deducting them from payables as before;
2. Whether there have been changes in EMM's management policy, for instance, a decision to allow customers to take extended periods of credit in order to double its revenue within five years;
3. Whether there have been changes in general commercial factors, for instance, a down-turn of the business climate in the industries in which EMM's customers are situated, hence rendering them unable to settle their debts within the credit terms;
4. Whether there are changes in specific commercial factors affecting only EMM, for instance, a higher proportion of EMM's products were sold on credit for the current year compared with last year;
5. Whether there have been changes in policy on provision of bad debt allowances and the write off of bad debts;
6. Any indication of fraud, for instance, teeming and lading by employees.

Answer 3

(a) Given that the risk of material misstatement of the existence of EMM's cash and cash equivalents is assessed as medium with an expectation that EMM's internal controls operated effectively during the period, it is reasonable for the team to adopt a combined approach in examining the existence of EMM's cash and cash equivalents.
Under the combined approach, the team should (1) perform tests of control to obtain appropriate sufficient evidence that the internal controls relevant to the existence of EMM's cash and cash equivalents had been operated effectively during the period, and (2) perform substantive procedures to obtain further evidence that the risk of material misstatement is reduced to an acceptably low level.

(b) Control activities that are relevant to the existence of EMM's cash and bank balances include:

Control activities

(i) Periodic and timely reconciliation of the balances as shown in the bank statements against the records of cash and cash equivalents by a competent and independent staff (or other forms of performance review that related different sets of data to one another);

(ii) Automated or manual checking of the arithmetical accuracy of records (or other forms of application controls in the processing of information about cash transactions);

(iii) Physical access to cash and computer terminals and/or programs that process cash transactions are restricted to authorised persons (or other forms of physical control); and

(iv) Different persons are assigned the different responsibilities of authorising cash transactions, recording cash transactions and the custody of cash (or other forms of segregation of duties).

Monitoring of controls

(i) Management review of bank reconciliations to ensure that the reconciliations have been performed in a regular and timely manner; and

(ii) Internal auditors' review/independent review and evaluation of the effectiveness of physical controls over cash and/or extent of segregation of duties in processing cash transactions (or other relevant monitoring of controls).

(c) Tests of controls on the control activities that are relevant to the existence of EMM's cash and bank balances include:

Tests of controls on control activities

Any two of the following:

(i) Asking the relevant member of staff how he/she prepares the bank reconciliations to determine whether bank reconciliations are prepared properly.

(ii) Inspection of the documentation of the reconciliations during the year of the balances as shown in the bank statements against the records of cash and bank balances to obtain evidence that the reconciliations have been performed regularly and in a timely manner by a competent member of staff;

(iii) Obtaining evidence that the controls have operated effectively during the year, and re-performing the automated or manual checking of the arithmetical accuracy of records to identify any defects of the controls;

(iv) Observation of whether the physical access to cash and computer terminals and/or programs that process cash transactions are actually restricted to authorised persons; and

(v) Observation and/or inspection of documentation of which persons are assigned the different responsibilities of authorising cash transactions, recording cash transactions and custody of cash and cash equivalents.
Tests of controls on monitoring of controls

Any two of the following:

(i) Asking the management how he/she reviews the bank reconciliations to determine whether the reviews have been conducted properly;

(ii) Inspection of the documentation of management's review of bank reconciliations during the year; and

(iii) Observation and/or inspection of documentation of the internal auditors' review/independent review and evaluation of the effectiveness of physical controls over cash and/or the extent of segregation of duties in processing cash transactions, and determination of whether the internal auditors'/independent evaluation was appropriate.

(d) Obtain confirmation from banks in accordance with the requirements of HKSA 505 External Confirmation. In particular, the auditor should have full control over the confirmation process.

Review bank reconciliations for the bank balance as at 31 December 2006, including enquiry into the nature of the major reconciliation items and inspection of documentation of the follow up actions and their disposal.

Perform analytical reviews on cash and cash equivalents records (including scanning through the records) to identify any unusual movements, particularly for short periods before and after the reporting date.

Check casting of the total cash and cash equivalents at the reporting date OR perform cash count and roll back to the reporting date if cash on hand was considered material.

**Answer 4**

The discovery of the fact that the general manager of one of the subsidiaries in EMM had misappropriated cash of HK$30,000,000 is a subsequent event under HKSA 560 Subsequent Events.

More specifically, it is an event occurring up to the date of the auditor's report.

According to HKSA 560, ABC & Co should consider the effect of subsequent events on EMM's financial statements and on the auditor's report.

In this case, when ABC & Co becomes aware of events which materially affect the financial statements, ABC & Co should consider whether such an event is properly accounted for and where appropriate adequately disclosed in EMM's financial statements.

If the misappropriation occurred before the reporting date, it was an adjusting event according to HKAS 10 Events after the Reporting Period. Since the amount of HK$30 million was material with reference to profit for the year and probably also the cash balance of HK$1,220 million, the misappropriated amount should be adjusted in the financial statements in such a case.

If the misappropriation occurred after the reporting date, it was a non-adjusting event according to HKAS 10. Since the amount of HK$30 million was material to the profit for the year and probably also to the cash balance of HK$1,220 million, the misappropriated amount and the incidence should be disclosed in the financial statements in such a case.

In both cases, ABC & Co should re-evaluate its assessment of the risk of material misstatement, in the cash balances in particular and in other account balances and classes of transactions in general.

The misappropriation of cash may indicate a weakness or an override in EMM's internal controls that ABC & Co should have identified and properly dealt with in the course of the audit.
Subsequent identification of the misappropriation may also suggest ABC & Co has erred in assessing the risk of material misstatement or in determining the nature, extent and timing of tests of controls or substantive procedures.

If there is no indication that ABC & Co had erred, subsequent identification of the misappropriation may suggest the existence of a higher risk of material misstatement due to fraud that cannot reasonably be identified through usual audit procedures according to HKSA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements. In such a case, ABC & Co may need to change the nature, scope and timing of further audit procedures in accordance with the guidelines in HKSA 240.

If, after performing the necessary further audit procedures, ABC & Co identifies other misstatements that should be adjusted or disclosed, ABC & Co should request that EMM makes the adjustment and/or disclosure in the financial statements.

CASE STUDY 5 (September 2006)

Answer 1

(a) In accordance with Section 440 of the Code of Ethics for Professional Accountants (the Code of Ethics), XYZ should find out whether the change of auditor was properly dealt with in accordance with the Companies Ordinance or other legislation.

According to the Code of Ethics, XYZ should also request ABC's permission to communicate with the previous auditor and to obtain professional clearance from the previous auditor.

Given that the previous auditor was a sole proprietor who died in a car accident, it would not have been practicable for XYZ to expect that the usual legal procedures regarding the change in auditors could be complied with. Given the unusual circumstance of the change in auditors, XYZ did not have an obligation to decline the appointment despite the absence of communication with the previous auditor.

(b) According to HKSA 220 Quality Control for an Audit of Financial Statements and the relevant Professional Ethics statements, prior to accepting a new client, the auditor should consider its independence and ability to serve the client properly, and the integrity of the client's management before accepting an engagement.

In so far as the competency of the new audit engagement of ABC is concerned, the following issues needed to be considered:

XYZ had never been involved in the jewellery industry prior to its appointment as the auditor of ABC, and thus did not have extensive experience in auditing financial statements of companies in this industry.

ABC also had business operations in Macau. While some of XYZ's existing clients may have had operations in Macau and the firm had some experience in auditing these companies, XYZ did not have extensive experience in auditing the jewellery industry in Macau.

In so far as the independence issue is concerned, at the first sight it appears that there are familiarity and self-interest threats as Mr King's son-in-law, whose wife holds 5% equity in ABC, is currently the administration manager of XYZ. However, as he is not a member of the assurance team involved in the audit of ABC, it is therefore considered that these two threats are not significant in this case.

If such an engagement were to be accepted, more experienced auditors would need to be assigned to the engagement team to handle the audit engagement for an industry which is relatively new to the firm.
Members of the engagement team should ensure that they have sufficient knowledge of the jewellery industry to enable them to identify and understand the events, transactions and practices which, in XYZ’s judgement, may have a significant impact on the financial statements, the audit or the auditors’ report.

XYZ may obtain knowledge about ABC’s business in a number of ways, for example, through discussion with various knowledgeable parties such as ABC’s management, other auditors and other knowledgeable people outside ABC, and by reading publications related to the jewellery industry, and reviewing legislation and regulations which may significantly affect ABC.

(c) Opening balances means those account balances which exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of (1) transactions of prior periods; and (2) accounting policies applied in the prior period.

Misstatements in opening balances could materially affect the current period’s financial statements.

For example, a material misstatement in the opening balance of ABC’s inventories would have a consequential effect on the profit or loss for the current year if it were not properly restated.

Since it is an initial audit engagement, XYZ does not have previously obtained audit evidence supporting the opening balances for ABC’s financial statements for the year ended 31 December 2005, ie balances as at 1 January 2005.

In accordance with HKSA 510 Initial Audit Engagements – Opening Balances, XYZ should obtain sufficient appropriate audit evidence about whether:

1. the opening balances contain misstatements that materially affect the current period’s financial statements;
2. the prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and
3. appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed.

To be satisfied that the opening balances do not contain material misstatements, XYZ should normally ask to review the work of the previous auditor. In this case, however, ABC’s prior period financial statements had been audited by a sole proprietor who had passed away.

Although XYZ may not be able to communicate with the previous auditor directly, XYZ may still consider the professional competence and independence of the previous auditor, eg by asking of ABC’s staff.

Where it is practicable, XYZ may obtain sufficient appropriate audit evidence regarding opening balances by reviewing the previous auditor’s working papers.

To ensure that appropriate accounting policies are consistently applied, XYZ should review the accounting policies adopted in the financial statements for the year ended 31 December 2004.

XYZ should consider (1) whether these accounting policies were appropriate, (2) whether the opening balances reflected the application of appropriate accounting policies and (3) that those policies were consistently applied in the current period’s financial statements.

If there were any changes in the accounting policies, XYZ should consider whether (1) the changes were appropriate and (2) were properly accounted for and (3) adequately presented and disclosed.
XYZ should consider the effect of the results of these procedures on the auditor’s report, eg XYZ should include a qualified opinion (limitation of scope) in the auditor’s report if XYZ is unable to obtain sufficient appropriate audit evidence concerning the opening balances.

(d) The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Risks of material misstatement at the financial statement level often relate to the entity’s control environment.

The nature of the risks arising from a weak control environment is such that the risks are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures.

In this case, Mr King and his family held 90% of the shares of ABC and Mr King was extensively involved in the operation of ABC. Mr King’s integrity and attitudes towards a sound internal control have significant implications for ABC’s control environment.

There seems to be little problem with Mr King’s integrity, given that (1) Mr King is a highly respected business man in the jewellery industry, (2) that the previous auditor had issued unqualified audit reports in the past 3 decades, (3) that the circumstances in the change of auditor do not suggest issues of Mr King’s integrity. (Candidates may conclude otherwise provided that they are able to support their view by facts given in the case.)

Although Mr King is heavily involved in the operation of ABC, there does not seem to be any other indication of internal control issues at the operational level, eg, lack of segregation of duties between accounting and sales.

However, even if XYZ is satisfied with Mr King’s integrity and the internal control of ABC, XYZ should still consider the possibility that Mr King may override the internal control and the effect of such action.

In addition to a weak control environment, other conditions may also lead to higher risks of misstatement at the financial statement level. They may include aggressive business strategies, significant business risks arising from changes or complexity of business operations, or unusually high pressures on performance measures and review.

In addition, the business risks of the jewellery industry are comparatively high because the identification and valuation of gems requires expert knowledge.

The presence of such circumstances was not apparent in the case.

**Answer 2**

(a) The valuation and allocation assertion of inventory refers to the assertion that the carrying amounts of inventory of ABC at the reporting date are appropriately included in the financial statements and any resulting valuation or allocation adjustments are appropriately recorded in accordance with the relevant accounting standards.

The following factors indicate a higher risk of misstatement in the valuation and allocation assertion of ABC’s inventory:

- As gems with similar appearance could have very significant cost differences, the correct identification of gems requires expert knowledge. Accordingly there is a higher inherent risk of misstatements in the valuation and allocation due to errors in recording their carrying values or selecting the right gems for production.
• In the absence of official invoices and receipts for gems purchased by Mr King in the markets, it is difficult to verify the costs of gems so acquired. In addition, the arbitrary allocation of cost to individual gems by Mr King in cases where two or more gems were picked up in a single purchase makes the valuation of these gems more complicated and difficult.

• As many different gems with significantly different costs and qualities are similar in appearance, their identification and valuation would depend entirely on experts in the field. Accordingly there is a higher inherent risk of misstatements for mistakes made in the identification or valuation process. There is also a higher inherent risk of misstatements for the auditors in obtaining sufficient and appropriate audit evidence that such work performed by the experts is adequate for the purpose of the audit according to HKSA 620.

• While most of the gems are quite long lasting when they are properly stored, their values may vary substantially over time. Accordingly there is a higher inherent risk of misstatements to determine their net realisable value.

• There is also a higher inherent risk of misstatements in determining the net realisable value of the gems kept by Mr King, as some of them may have been stored for a rather long period in his private safe. Without the assistance of experts in the valuation, it is very difficult to ascertain the market value of these gems.

(b) The specific audit objective is to verify that the carrying amounts of inventory of ABC at the reporting date are appropriately included in the financial statements and any resulting valuation or allocation adjustments are appropriately recorded in accordance with the relevant accounting standards.

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.

Select samples, particularly those expensive ones, from the inventory list and confirm with experienced staff of ABC 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 gems in the sample and their valuation in accordance with the procedures set out in HKSA 620 Using the Work of an Auditor's Expert. Verify the acquisition costs of gems through checking official invoices and receipts of suppliers.

Ensure that the sample for expert confirmation includes a sufficiently large number of gems purchased by Mr King from various street stalls.

Investigate ABC's inventory accounting policy, particularly that relating to overhead allocation, to consider whether the policy complies with relevant accounting standards.

Re-perform some overhead cost allocations to verify whether the procedures are performed in accordance with ABC's stated accounting policies.

Ask ABC's management about any deviations from the policy and assess the reasons put forward by them.

Ask ABC's management about the process for identification of obsolete and slow moving inventories, eg identification of movement in slow moving finished goods after the reporting date.

Perform analytical procedures, eg, compare finished goods to revenue ratios of current and prior years, to consider whether the inventory holdings are reasonable.

Review sales of finished goods after the reporting date and ensure that they are sold above cost.
Enquire how ABC’s management assesses the inventory valuation. Obtain or prepare an inventory aging analysis. Determine whether any write down of finished goods to inventory is necessary.

(c) The existence assertion of inventory means the assertion that inventory reported in the statement of financial position physically existed at the reporting date. The following factors indicate a high risk of misstatement in the existence assertion of ABC’s inventory:

- ABC’s inventory consists of various types of gems, which are in general small in size but high in value. Accordingly, there is a rather high inherent risk of unreported loss due to theft.
- ABC has a wide variety of gems as raw materials for the production of different jewellery. There is a higher inherent risk of misstatements due to recording or selection of the wrong gems for production.
- Correct identification of gems with similar appearance requires expert knowledge. The inherent risk of misstatements due to mistaken identification of such gems will therefore be higher, both for ABC’s staff and for the auditors.
- Many gems are quite long lasting provided that they are properly stored. As proper storage of such gems requires expert knowledge, there is a higher inherent risk of misstatements due to improper storage.
- In addition, many gems have a high value but a comparatively small size. Accordingly there will be a higher inherent risk of mislaying such inventory items.
- Finished goods are kept in three different locations: two shops in Hong Kong and one in Macau. Staff of ABC (and also the auditors) with the appropriate expertise in gems may have difficulties in conducting physical inventory counts simultaneously at the year end for all these locations to verify the existence of finished goods.

(d) The specific audit objective is to verify that the carrying amount of inventory reported in the statement of financial position physically existed at the reporting date. ABC’s inventory is considered to be material as it represents approximately 4.26 times ABC’s profit before tax for the year under review.

Since the inventory is material to the financial statements, the auditors should, in accordance with HKSA 501, obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at the physical stocktaking by themselves or another auditor or a suitably qualified person representing them, unless impracticable.

During attendance of ABC’s physical stocktaking, XYZ should review instructions from ABC’s management, observe count procedures and perform test counts. XYZ should assess the independence and competence of the counting team, eg whether ABC staff other than from the warehouse have been sufficiently involved and whether the inventory counting is supervised by an appropriately experienced and qualified staff member.

When performing test counts, XYZ should trace items selected from the records to the physical inventory and items selected from the physical inventory to the count records.

In addition, XYZ should consider performing cut-off procedures on the details of the movement of inventory just prior to, during and after the count.

XYZ should also obtain expert confirmation about the identification of gems for some of the samples tested.
CASE STUDY 6 (February 2006)

Answer 1

(a) (i) The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Risks of material misstatement at the financial statement level often relate to the entity's control environment.

The control environment of ABC includes: (1) its governance and management functions; and (2) the attitudes, awareness, and actions of ABC directors (eg, Paul Cheung), and the management (eg, Mr Wong and his wife Helen) concerning ABC's internal control and its importance.

The nature of the risks arising from a weak control environment is such that the risks are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures.

In this case, Mr Wong, the Personnel and Administrative Manager, took over the work of the supervisor of the accounts department. This indicated that Mr Wong lacked awareness of the importance of the principle of segregation of duties in a sound control environment.

Mr Paul Cheung's attitudes towards a sound internal control seemed to be affected by his close relationship with Mr Wong and Helen, putting three important functions, namely, the accounting function, the warehouse function, and the personnel function, under the control of Mr Wong and his wife Helen.

Such a concentration of management power poses a higher risk of error. Errors may not be identified due to lack of checking by independent parties.

Risk of fraud would also be higher since any fraudulent action could easily be concealed.

In addition to a weak control environment, other conditions may also lead to higher risks of misstatement at the financial statement level. Such conditions may include aggressive business strategies, significant business risks arising from changes or complexity of business operations, and unusually high pressures on performance measures and review.

In this case, the Company has entered a new market, ie, the Mainland, and has adopted a new mode of business practice, ie, consignment sales.

ABC may not be so familiar with the new business environment and may therefore be exposed to higher business risks.

In addition, there was a high staff turnover in ABC's accounts department. If any replacement, eg, Mr Wong, is not competent enough in financial reporting and internal controls, the risk of material misstatement at the financial statement level would be higher.

On the basis of the factors discussed above, risk of material misstatement at the financial statement level for the financial statements of ABC for the year ended 31 December 2005 is assessed as medium (or high).

(ii) The overall responses to the medium (or high) risk of material misstatement at the financial statement level are matters of professional judgment. Appropriate responses in this case may include:

(1) emphasising to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence;
(2) assigning more experienced staff or those with special skills or using experts;

(3) providing more supervision to the audit staff; or

(4) incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.

NTC may also make general changes to the nature, timing or extent of audit procedures as an overall response.

Other specific responses may be appropriate to the situation, eg, more extensive procedures in examining the occurrence of staff costs, completeness of revenue and trade receivable etc.

(b) Effectiveness of the trade debtors' and trade creditors' confirmation on sales and purchases cut-off

'Cut-off' refers to the assertion that transactions and events have been recorded in the correct accounting period.

A proper cut-off in sales (or purchases) means that ABC's recorded sales (or purchases) do not include sales (or purchases) transactions that occurred after the reporting date, and that all sales (or purchases) before the reporting date are included in the sales (or purchases) for the year.

External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertions in the financial statements or related disclosures.

External confirmation of the balances of trade debtors provides reliable and relevant audit evidence regarding the existence of the receivables as at the reporting date. The confirmation of trade debtor (and trade creditor) balances also provides audit evidence regarding the operation of cut-off procedures for sales (and purchases).

The sending of confirmation requests to trade debtors and trade creditors with significant balances in the ledger at the reporting date as suggested by the audit assistant provides reliable evidence that sales and purchases transactions relating to the unsettled balances at the reporting date occurred before the reporting date.

However, these confirmation procedures may not be necessary in this case for cut-off testing, since the audit assistant may check source documents relating to recorded sales or purchases to obtain evidence that the transactions actually occurred before the reporting date.

The principal difficulty that the audit assistant faced is that records of post year end transactions were not yet available. The audit assistant cannot perform reviews of subsequent year transactions to obtain evidence that sales and purchases occurring during the current year had not been incorrectly recorded as transactions occurring in the subsequent year.

The sending of confirmation requests to trade debtors and trade creditors with significant balances in the ledger at the reporting date is not effective in obtaining evidence of the cut-off sales or purchases since some transactions occurring before the reporting data may not have been recorded by ABC at all.

To improve the effectiveness of the confirmation procedures for the purpose of cut-off testing, the audit assistant should send confirmation requests to an appropriate sample of trade debtors and trade creditors with zero balance as well as material balances. In addition, the audit assistant should send confirmation requests to all trade debtors and creditors with material transactions during the year, regardless of their year-end balances.
However, these improved procedures still have limitations for cut-off testing. If the existence of the customers or suppliers is not identified in ABC’s records, eg, a new customer transacted with ABC shortly before the reporting date, the audit assistant would not be able to detect any transactions between ABC and the new customer before the reporting date.

The team should also consider the implications of the failure to perform a review of documentary control over inventory movements subsequent to the reporting date in accordance with HKSA 560 Subsequent Events.

The auditor should request ABC to update the books and records.

(c) (i) Possible causes of the HK$900,000 inventory write-off

In general, there may be two reasons for the write-off: (1) inventory records and physical records are different, and this may be caused by inaccurate inventory systems or fraud in misappropriation; and (2) writing down of the inventory to its net realisable value.

If the write-off was due to inaccurate inventory systems, it would not affect any particular assertion of the inventory balance (provided that all errors in inventories had been identified and corrected). It indicates however that there may be defects or weaknesses in the internal control systems, and this may affect the assessment of the auditor regarding the risk of material misstatement at the financial statement level (eg, change from medium to high).

If the write-off was caused by stock loss due to fraud, it may affect the disclosure and presentation assertion. Given that the write-off represents 1.5% [HK$900,000/HK$60,000,000] of ABC’s sales revenue for the year ended 31 December 2005 and 4.5% [HK$900,000/HK$20,000,000] of its inventory as at 31 December 2005, the nature of the write-off may need to be disclosed in the notes to financial statements according to relevant accounting standards.

If the write-off is to recognise provision for net realisable value, it would affect the valuation and allocation assertion of inventory.

(ii) If the auditor considers that the write-off might have been caused by fraud, the auditor should adopt HKSA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements in examining the potential fraud identified.

In accordance with HKSA 240, when NTC, in view of the unusual write-off of inventory, assesses the risk of material misstatement due to fraud as high, NTC should:

1. determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level; and
2. design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks at the assertion level.

NTC may respond to the risks of material misstatement due to fraud at the financial statement level by:

1. increasing professional scepticism;
2. considering the assignment and supervision of personnel;
3. considering the accounting policies used by the entity; and
4. incorporating an element of unpredictability in the selection of the nature, timing and extent of audit procedures.

In designing and performing further audit procedures on its inventory, NTC may consider increasing the extent of the procedures applied to reflect the assessment of the risks of material misstatement due to fraud.
If the auditor considers that the write-off did not involve any fraud and was purely a provision for reduction in the inventory's net realisable value, the auditor should adopt HKSA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

An ‘accounting estimate’ is an approximation of the amount of an item in the absence of a precise means of measurement. A write-off to reduce an item of inventory to its estimated realisable value is an example of an accounting estimate.

In accordance with HKSA 540, NTC should adopt one or a combination of the following approaches in the audit of the accounting estimate of the HK$900,000 write-off:

1. review subsequent events which provide audit evidence of the reasonableness of the estimate made;
2. review and test the process used by management to develop the estimate;
3. test the controls over how management made the estimate, together with appropriate substantive procedures; or
4. use an independent estimate for comparison with that prepared by management.

It is not likely that NTC would adopt the fourth approach in this case.

In reviewing and testing the process used by the management of ABC, NTC may:

1. evaluate the data and consider the assumptions on which the estimate is based, eg, NTC should determine whether a specific provision or a general provision based on the inventory aging analysis has been made, and whether the provision policy conforms with the relevant accounting standards;
2. test the calculations involved in the estimate eg, re-perform the calculation;
3. compare estimates made for prior periods with the actual results of those periods, eg, determine whether the write-off in the current year was unusual in view of the trend of write-off to net realisable value in past years; or
4. consider management’s approval procedures, eg consider whether the approval procedures were materially different from past practice.

**Answer 2**

(a) The major audit issues on ABC’s consignment sales recognition are:

Some drug stores in Mainland China 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. This affects the completeness of the consignment sales.

There is also a risk that 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. This affects the occurrence of the consignment sales.
The practice of consignment sales is new to ABC. ABC'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 sales of goods transactions to the drug stores. This will affect the accuracy of the consignment sales.

(b) In order to properly account for the recognition of consignment sales transactions, the following audit procedures may need to be performed:

1. Discuss with local management the internal controls that are in place to:
   (i) identify the existence of consignment sales; and
   (ii) ensure proper recognition of consignment sales.

2. Obtain an understanding of ABC's arrangements for consignment sales by reviewing its consignment sales agreements with major consignees.

3. Perform walkthrough tests to confirm the auditors' understanding of the client's system and perform compliance tests on key internal controls.

4. Perform cut-off tests on goods sold by the consignees before and after the year-end.

5. Perform an analytical review of the consignees' receivables balances and review subsequent payment movement by vouching for relevant supporting documents to note any cut-off errors.

6. Review correspondence with consignees, particularly in relation to the consignment sales and/or consignment sales returns and look for any delay in sales recognition.

7. Review periodic consigned goods reports provided by the consignees to match the client's internal documentation. Ensure that any variance found was properly explained.

8. Review and obtain explanations for any long outstanding receivables by the consignees, which may indicate early recognition of consignment sales.

9. Attend an inventory count to ensure the existence of consignment stocks if the amount is material. Review the client's consignment stock reports and compare them to the inventory count results to ensure the accuracy of the client's consignment stock balances.

10. Perform direct circularisation to selected consignees for sales transactions balances and consignment stocks balances in any particular time frame to ensure the accuracy of record keeping between client and consignees.
Glossary of terms
**Accountability** (corporate) refers to whether an organisation (and its directors) are answerable in some way for the consequences of their actions.

**Accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement.

**Adverse opinion** should be expressed when the effect of a **disagreement** is so **material and pervasive** to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

**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.

**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.

**Analytical procedures** are tests conducted during an audit designed to help an auditor understand an entity’s business and any likely areas of misstatement.

**Anomaly** is defined as a misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

**Application controls** are manual or automated procedures that specifically operate at a business process level. They can be preventative or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, they relate to specific procedures used to initiate, record, process and report transactions or other financial data.

**Applied criteria.** The criteria applied by management in the preparation of the summary financial statements.

**Appropriateness** is the measure of the **quality** or **reliability** of the audit evidence.

**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.

**Audit** of financial statements: the process to enable the professional accountant to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework, giving a true and fair view of the entity’s financial position at the period end and of the results of its operation for the period ended. An audit of financial statements is an example of an assurance engagement.

**Assurance engagement**: 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.

**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.

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

**Auditor’s expert**: an individual or entity possessing special skill, knowledge and experience in a particular field other than accounting and 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.
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.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Audit sampling involves the application of audit procedures to less than 100 per cent of the items within an account balance or class of transactions such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the entire population. Audit sampling can be applied using either a statistical or non-statistical approach.

Audit software is used by auditors to interrogate an entity's data and files. It may be generic audit software or custom audit software and will be used to carry out substantive procedures.

Audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan.

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.

Business risk is the risk inherent to the entity in its operations. It is risks at all levels of the business. It is split into three categories.

Cold review: is a peer review carried out after the audit report is signed.

Comparative financial statements are amounts and other disclosures of the preceding period included for comparison with the financial statements of the current period, but do not form part of the current period financial statements.

Compilation engagement. In a compilation engagement, the accountant is engaged to use accounting expertise as opposed to auditing expertise to collect, classify and summarise financial information. No assurance will be expressed on the financial information.

Compliance risk is the risk that arises from non-compliance with the laws and regulations that surround the business.

Component auditor: an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.

Computer-assisted audit techniques (CAATs) are the applications of auditing procedures using the computer as an audit tool.

Contingent fees (or percentage fees) are fees which are calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed.

Control activities are those policies and procedures which are established to achieve the entity's specific objectives and are designed to prevent, or to detect and correct errors.

Control environment: 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.

Control risk (CR) is the risk that a material misstatement that could occur in an assertion and that could be material, 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.

Corresponding figures are amounts and other disclosures for the preceding 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'). These corresponding figures are not presented as complete financial statements capable of standing alone, but are an integral part of the current period financial statements intended to be read only in relationship to the current period figures.
Glossary of terms

**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 financial statement.

**Date of the financial statements** is the date of the end of the latest period covered by the financial statements.

**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.

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

**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 a trust over which the individual or entity has control

**Disclaimer of opinion**: should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements. Or in rare cases, the auditor is not able to form an opinion on the financial statements due to the potential interaction of the multiple uncertainties and their possible cumulative effect on the financial statements.

**Due diligence** reviews are a specific type of review engagement. A typical due diligence engagement is where an advisor (often an audit firm) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts. This is important when determining purchase price. Similarly, due diligence can also be requested by sellers. When a company is taken over or merged, all parties need to be assured that what is purported to be actually is. It can be carried out by actuaries, surveyors or lawyers. Normally, a takeover is not completed until a due diligence report has been completed.

**Electronic commerce (e-commerce)** means conducting business electronically via a communications link.

**Electronic data interchange (EDI)** is a form of computer to computer data transfer. Information can be transferred in electronic form, avoiding the need for the information to be re-inputted somewhere else.

**Electronic mail (e-mail)** is a system of communicating with other connected computers or via the Internet in written form.

'Element of financial statement' or 'element' means an 'element, account or item of a financial statement'.

**Emphasis of matter** in certain circumstances, an auditor's report may be modified by adding an emphasis of matter to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The auditor may also modify the auditor's report by using an emphasis of matter paragraph to report matters other than those affecting the financial statements as such importance that they are fundamental to users' understanding.

**Error** means either control deviations, when performing tests of control, or misstatements, when performing substantive procedures.
Estimation uncertainty refers to the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

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.

Expected error is the error that the auditor expects to be present in the population.

Experienced auditor refers to an individual who has practical audit experience and a reasonable understanding of the audit processes, accounting and legal requirements, the business environment and the auditing and financial reporting issues relevant to the entity's industry.

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.

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.

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.

Financial risks are the risks arising from the financial activities or financial consequences of an operation, for example, cash flow issues or overtrading.

Financial statement assertions are the set of information that management of an entity provides its auditors as the financial statements. Closely interrelated, as used by the auditor must use their judgment and experience to consider the different types of potential misstatements that may occur.

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. Fraud may be perpetrated by an individual, or colluded in, with people internal or external to the business.

Fraud risk factors are events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Fraudulent financial reporting involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users.

General IT 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. It aims to establish a framework of overall control over the computer information system's activities. They commonly include controls over data centre and network operations, system software acquisition, change and maintenance, access security, and application system acquisition, development and maintenance.

Going concern assumption: an entity is viewed as continuing in business for the foreseeable future with neither the intention to liquidate or cease trading or has no realistic alternative. 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.

Group engagement partner: the partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Group engagement team: partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.
Group-wide controls are controls designed, implemented and maintained by group management over group financial reporting.

Hot review: is a peer review carried out before the audit report is signed.

Inconsistency exists when other information contradicts information contained in the audited financial statements.

Independence in appearance: the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised.

Independence of mind: the state of mind that permits the provision 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.

Indirect financial interests are beneficially owned through a collective investment vehicle such as trust over which the individual or entity has no control.

Information system relevant to financial reporting is a component of internal control that includes the financial reporting system. It consists of the use of standard or non-standard journal entries used to initiate, record, process and report transactions and also to maintain accountability for the related assets, liabilities and equity.

Inherent risk (IR) is the susceptibility of an account balance or class of transactions to a misstatement that may be material either individually or when aggregated with other misstatements, based on the assumptions that there are no related internal controls.

Integrity means straightforward dealing and completeness. 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.

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 control is the process designed and implemented 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.

Internet: a global network connecting millions of computers.

Joint audit: one 'where two or more auditors are responsible for an audit engagement and jointly produce an audit report to the entity'.

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

Listed entities are those whose shares have been admitted to a recognised exchange, such as the Stock Exchange of Hong Kong.

Lowballing is the term used to describe the situation where a firm quotes a significantly lower fee for an assurance service than would be charged by a competitor firm usually in order to gain other more lucrative business.

Management bias is a lack of neutrality by management in the preparation of information.

Management’s expert is an individual or entity 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.
**Materiality** is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

**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.

**Misappropriation of assets** is a particular type of fraud involving the wrongful taking of an entity's assets.

**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.

**Monitoring of controls** is a process to assess the effectiveness of internal control performance over time. It includes assessing the design and operation of controls on a timely basis and taking necessary corrective actions modified for changes in conditions.

**Negative assurance** is assurance of something in the absence of any evidence arising to the contrary. In effect, this means the auditor is saying, 'I believe that this is reasonable because I have no reason to believe otherwise.'

**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-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 and fail to recognise a misstatement or deviation.

**Non-statistical sampling** is the approach to sampling where the auditor does not use statistical methods and draws a judgmental opinion about the population.

**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.

**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.

**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.

**Other matter paragraph:** a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

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

**Peer review:** a review of an audit file carried out by another partner in the assurance firm.

**Population** is the entire set of data from which a sample is selected and about which an auditor wishes to draw conclusions.

**Public interest entities** are those which for some reason (size, nature, product) are in the 'public eye'. Professional accountants should treat these as if they are listed entities.
Qualified opinion is expressed when:

(a) the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements

(b) the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

Related party. A party that is either:

(a) A related party as defined in the applicable financial reporting framework (ie 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 joint control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity or is a member of the key management personnel of the reporting entity or of a parent of 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)

– joint ventures or being associates

– owners who are close family members

– common key management

– ex-employee

Review engagement: to enable a professional accountant to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the professional accountant's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

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

Sampling units are the individual items constituting a population.

Service organisation: an organisation that provides services to another entity.

Significant component: a component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

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.

Significant risks are those that require special audit consideration.

Single financial statement or a specific element of a financial statement includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.
**Special purpose financial statements**: financial statements prepared in accordance with a special purpose framework other than a general purpose framework.

**Special purpose framework**: financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.

**Stakeholders**: 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.

**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.

**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.

**Substantive procedures** are audit procedures performed 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

**Sufficiency** is the measure of the quantity of audit evidence.

**Summary financial statements**: Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.

**Test data** techniques are used for tests of controls. By inputting a sample of transactions or other relevant data into an entity's computer system, and comparing the results obtained with pre-determined results, an auditor is able to check that the entity's systems are processing data in the correct way.

**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.

**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.

**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.

**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.

**World Wide Web**: a system of Internet servers that support specially formatted documents. A group of documents accessed from the same base web site is known as a website.

**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.
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