Quality Assurance
Annual Report 2011
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Foreword

Fellow members

The report covers the activities and output of the quality assurance department for 2011. The report keeps you up-to-date with the work of the department and brings to your attention to significant and common matters identified through the practice review and professional standards monitoring programmes.

You will see that we have again exceeded our targeted number of practice reviews. Since the revised practice review programme began in 2007 we have carried more than 550 practice reviews. We have made good progress on the second three year cycle of reviews of listed company auditors and this will be completed by the end of 2012. In 2011 we also introduced interim visits to a number of firms, other than the Big Four, which have sizeable numbers of listed company clients. The Big Four continue to be reviewed annually due to the degree of public interest that there is in the clients of these firms.

What we have discovered during our practice reviews has generally been positive. Our members have been extremely cooperative and have hastened to make changes where necessary, and indeed, in some cases have expressed their appreciation for the guidance they have received as a consequence of the review.

However, the practice review programme has been in place long enough for the department and the practice review committee to have developed concerns about a handful of firms that are seriously out of touch with the requirements of professional standards. It is not always easy to establish the causes of such shortfalls. Sometimes it comes down to a mismatch between the resources (staff numbers, experience and skills) available to the firm and the nature of the firms’ client base. Sometimes we have to unfortunately conclude that firms and individuals lack the commitment to maintain their knowledge and understanding of professional standards. If a firm is reviewed for a second, or even third, time, it is unacceptable that no or minimal progress has been made in addressing previous review findings, especially when the committee’s directions on remedial action had been clearly expressed. It is also, to say the least, frustrating to review a firm in 2011 and find that it has made no effort to develop and bring in policies and procedures to address the requirements of HKSQC1, which has been in issue since 2005. We remain committed to the educational value of practice review but we have the responsibility to uphold the quality and reputation of the audit profession in Hong Kong.

As for professional standards monitoring, this valuable mechanism shows us the quality of financial reporting by listed companies and allows us to communicate important messages to our members. We work closely with the Stock Exchange of Hong Kong (HKEx) and the Financial Reporting Council (FRC), which both carry out financial statement review programmes similar to our professional standards monitoring programme.

By ensuring there is no duplication between the programmes, the Institute, HKEx and the FRC can together provide comprehensive observations and guidance that will support and enhance quality financial reporting in Hong Kong. In 2011 the three organizations jointly presented a forum on the outcomes of their review programmes that was attended by around 300 members from practicing and business backgrounds.

The review of auditor regulation in Hong Kong continues and the Institute is taking a leading role. There will inevitably be significant changes ahead and the Institute is committed to ensuring that these changes are of the highest quality and will allow Hong Kong to be fully recognized and represented internationally in this field. We are also committed to maintaining the acknowledged quality of the Institute’s quality assurance work and the value it brings to our members and the standing of Hong Kong.

I thank the vast majority of our practicing members, and their staff, who have accommodated and cooperated with our practice reviews and professional standards monitoring enquiries. The full value of our quality assurance programmes depends on us all working together in the common interests of the profession and Hong Kong.

Chris Joy
Executive Director, Hong Kong Institute of CPAs
March 2012
About us

The main functions of the Quality Assurance Department (“the QAD”) are to conduct practice review and professional standards monitoring. Both programmes serve the wider public interest by ensuring that the quality of auditing and financial reporting in Hong Kong is maintained and enhanced and provide valuable content for the Institute’s member learning and development activities. Direct interaction with members on auditing and financial reporting matters is a very effective way to give advice and assistance on the application of professional standards.

Practice review programme
The objective of practice review is to monitor the quality of work of all practising certificates holders in Hong Kong engaging in provision of audit and other related assurance services (“Practices”). The Professional Accountants Ordinance (“PAO”) has empowered the Institute to carry out practice review since 1992. The approach to practice review was revised in 2006 to bring it up to international standards.

The Practice Review Committee (“the PRC” or “Committee”) is a statutory committee responsible for exercising the powers and duties given to the Institute as the regulator of auditors in Hong Kong under sections 32A to 32I of the PAO. The QAD reports to the Committee and the Committee makes decisions on the results of practice reviews. According to section 32A of the PAO, at least two thirds of the Committee members must hold practicing certificates. The practicing members of
the Committee are drawn from the full spectrum of audit firms, representing small Practices through to the Big Four firms. Non-practising members are also included in the Committee to bring an additional perspective to Committee decisions. The composition of the Committee is reviewed by the Nomination Committee of the Institute every year to ensure a balanced composition. Please refer to Annex for members of the Committee.

Professional standards monitoring programme

The programme was established in 1988 and has been developed to be a comprehensive and extensive financial reporting review programme. The objective of the programme is to enhance the quality of financial reporting and the application of professional standards in Hong Kong.

The QAD carries out regular reviews of published financial statements of listed companies in Hong Kong. Enquiries are raised with members (primarily auditors of listed companies) in relation to matters identified by the reviews. As the programme is primarily educational, recommendations on how to improve the quality of financial statements specific to the issues identified are provided in correspondence as appropriate. The QAD also communicates matters identified by the programme to the wider membership through Financial Reporting and Auditing Alerts, the QAD annual report and forums.

The programme is supported by external reviewers from Big Four and medium-sized practising firms and the Professional Standards Monitoring Expert Panel (“Expert Panel”). Please refer to “Our work” section in respect of the role and responsibilities of external reviewers and the Expert Panel. The Expert Panel comprises members from Big Four and medium-sized practising firms, a representative from Hong Kong Exchanges and Clearing Limited (“HKEx”) and a non-practising member. Please refer to Annex for members of the Expert Panel.
Oversight of our work

The responsibility for oversight of QAD activities rests with the Standards and Quality Accountability Board (“the SQAB”). The SQAB ensures that QAD activities are carried out in accordance with strategies and policies determined by Council and in the public interest. The SQAB receives and reviews yearly plans and budgets and regular progress reports from management and reports to Council on its observations and views in relation to performance and operations. Please refer to Annex for members of the SQAB.
Our work

Practice review programme

The practice review process can be divided into three stages:

**Stage 1 – Preparation**
- Select Practice for visit
- Agree on visit date and request key documents
- Preliminary assessment of submitted key documents

**Stage 2 – On-site Visit**
- Opening meeting
- Conduct interviews
- Review compliance with HKSQC1 and review selected audit files
- Summarise findings and recommendations
- Exit meeting

**Stage 3 – Reporting**
- Draft report to Practice for formal response
- Review Practice’s response
- Submit Reviewer’s report to the PRC for consideration
- Advise Practice of the PRC decision
- Monitor follow up action, if needed

Selection of Practices for review is based on their risk profiles, primarily from information obtained from the electronic self-assessment questionnaire (“the EQS“) and other relevant sources:

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<thead>
<tr>
<th>Practices</th>
<th>Frequency of review</th>
<th>Note</th>
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<tr>
<td>Big Four</td>
<td>Annually</td>
<td>1</td>
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<tr>
<td>Practices with a significant number of listed clients</td>
<td>Subject to a full review at least every three years and an interim review during the three-year cycle</td>
<td>2</td>
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<tr>
<td>Other Practices with listed clients</td>
<td>Subject to review at least every three years</td>
<td>3</td>
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<tr>
<td>Other Practices</td>
<td>Based on risk profiles and random selection</td>
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Note:

1. This recognizes the predominance of listed and other public interest entities in Big 4 client portfolios.

2. From 2011, Practices with more than 20 listed clients will receive an additional interim review. Four interim reviews were carried out in 2011. This development shows the Institute’s commitment to address areas of higher public interest. Interim reviews focus on key changes in systems and procedures, action taken following the previous practice review, current auditing and accounting issues, and review of completed listed company audit engagement(s).

3. This is in line with international best practice. The QAD has procedures in place to identify Practices that take up listed client engagements for the first time. Once identified, these Practices will be subject to review under the three-year review cycle of Practices with listed clients.

4. Risk profiles are determined with reference to information obtained from the EQS and other relevant sources. Practices with other public interest clients, for example, banks, insurance companies, securities brokers, insurance brokers, entities receiving government subvention, solicitors and schools, etc, are given priority for reviews. A number of Practices are selected for reviews on a random basis to ensure that all Practices will have a chance of being selected.
The scope of each review includes obtaining an understanding of the Practice’s system of quality control, assessing compliance of policies and procedures with HKSQC 1 and reviewing conduct of audit work. The detail and extent of review work that the QAD will need to carry out varies from practice to practice depending on the size of the Practice and the nature of the client base.

How Practices applied professional skepticism in the audit process was an area of particular attention in 2011, especially as there was a lot of press coverage during the year suggesting that standards of corporate governance and financial reporting in some mainland companies may not be of the highest standard. The QAD took steps to understand the quality control procedures Practices had in place to ensure appropriate risk assessments were undertaken for clients that had significant operations in Mainland China. Practice reviewers also considered whether Practices had applied sufficient professional skepticism in assessing the reliability of evidence obtained in respect of areas such as impairment of assets, valuations and going concern which are likely to involve considerable management judgement.

Matters identified during reviews are fully discussed with the Practices. The QAD is responsible for drawing conclusions on the review and making recommendations to the PRC for consideration and decision. The PRC having regard to the report and any response by the Practice to the matters raised in the report may act under the power given by the PAO, to:

- conclude a practice review with no follow up action required (“direct closed”);
- make recommendations and specific requests to a Practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings (“required follow up action”);
- instruct that another visit is required (“required follow up visit”); or
- make a complaint to initiate disciplinary action.

Each Practice is sent a formal notification of the PRC decision. The QAD monitors the progress of follow up action undertaken by Practices at the direction of the PRC.

The PRC may, via Council of the Institute, refer any case related to listed company audits to the FRC when the outcome of practice review is poor.

**Professional standards monitoring programme**

Unlike the practice review programme under which the QAD conducts site visit to Practices, interaction with members under this programme is mainly through correspondence. Enquiry letters are issued to members in respect of issues identified. Enquiries focus on financial reporting matters such as the appropriateness of accounting treatment and disclosures but there are occasions when enquiries might be raised on potentially significant audit matters.
Members of the Expert Panel ("panel members") are involved in all relevant stages of the review process to help the QAD deal with significant, complex or controversial matters identified during the reviews. Panel members offer their views on the application of professional standards in relation to matters raised by the QAD and assist in assessing responses to enquiry letters and reaching an appropriate outcome. With the strong support of panel members, the QAD ensures that enquiries made under the programme are relevant and developed with due consideration.

The professional standards monitoring process can be divided into three stages:

**Stage 1 – External review**
- External reviewers carry out initial review on the published financial statements assigned by the QAD

**Stage 2 – QAD review**
- The QAD reviews the reports prepared by external reviewers and decides whether enquiry is necessary.
- The QAD consults the Expert Panel on significant, complex or controversial issues

**Stage 3 – Follow up**
- The QAD reviews reply letters from members and decides whether further enquiry is necessary or other appropriate actions for the case.
- The QAD consults the Expert Panel on significant, complex or controversial issues.
Selection of financial statements for review is risk-based. The following chart shows the basis of financial statements selected for review in 2011.

The QAD also considered the proportion of market share of respective auditors in allocating the number of financial statements reviews for auditors. That means auditors which have more listed clients will have a higher chance of being selected. The following chart is an overview of distribution of auditors in respect of the financial statements reviewed in 2011.
Our review outcomes

Practice review programme

The number of reviews carried out every year has increased steadily from 82 in 2008 to 181 in 2011.
2011 was the second year of the second three-year review cycle of Practices with listed clients. Since the launch of the revised practice review programme in 2007, a total of 72 Practices with listed clients have been visited by the QAD. For Practices where the QAD and the PRC were not satisfied with audit quality, follow up visits were arranged to ensure that findings from practice reviews had been properly addressed and that improvement was made on weaknesses identified. The PRC has raised a complaint against one Practice with listed clients on the grounds that the Practice had serious practice review findings of non-compliance with professional standards and serious technical failings.
The PRC met on eleven occasions in 2011 and considered reports on 168 Practices. The PRC concluded that 44 cases should be closed without requiring any follow up action. In 119 cases, Practices were required to fulfill specific actions and/or submit a status report on actions taken in response to practice review findings. Five cases required a follow up visit to assess the effectiveness of remedial actions taken.

In addition to the 168 “first time” practice reviews, 14 follow up visits were reported to the PRC in 2011. Three were closed on the basis of adequate remedial actions having been taken, nine required further follow-up actions and two required further follow up visits. Follow up visits are arranged to monitor progress made by Practices where practice review results were not satisfactory.

Over the last four years, approximately 25% of “first time” practice review cases reported to the PRC have been directly closed. The majority of reviews have required remedial action, follow up visits or even disciplinary action.
The results are further analyzed into (1) Practices with listed clients and (2) Other Practices.

For Practices with listed clients, it can be seen that while there is a decreasing trend in Practices being required to undertake remedial action or submit status reports. This is encouraging, coming from efforts by Practices to improve audit quality.

![Practice review cases reported to PRC (Practices with listed clients)](chart.png)

- Direct closed
- Required follow up action
- Required follow up visit

- 2008 2009 2010 2011
A small percentage of other Practices required follow up visits. However, there has been a regular pattern in the past few years that over 70% of Practices reviewed are required to undertake follow up action or submit status reports. Only about 20% of the reviews are directly closed. These continuing patterns suggest that audit quality has not improved over these years or responses to review findings were not adequate to address review findings.

There are various reasons that a case cannot be closed directly. Most Practices were able to provide a written response to the QAD on the draft report. However, many of the responses do not address the findings satisfactorily. For example:

- no appropriate or effective follow up action was proposed to address significant findings identified;
- unable to demonstrate real understanding of or inability to resolve the issues;
- the responses were very general or brief such that the QAD could not understand what follow up actions or procedures were being proposed to address the findings;
- no timeframe provided for follow up actions to be undertaken; or
- no commitment was shown to findings being properly addressed.

For some other cases, findings identified during practice review were considered to be very significant. Therefore even if the Practice had provided a relevant action plan, the PRC still considered it necessary to monitor progress to ensure that action taken was effective in addressing identified weaknesses.
Professional standards monitoring programme

In 2011, the QAD reviewed 82 sets of published financial statements and followed up 14 cases brought forward from the previous year. During the year, the QAD issued 59 letters and handled 42 responses from auditors. Amongst 87 cases closed, 74 related to financial statements reviewed during the year. In 2011, the QAD consulted with panel members on complex or controversial issues arising from reviews of financial statements of eleven listed companies. More than one round of consultation was necessary for some cases.

The lower volume of reviews for 2011 compared to 2010 was primarily due to substantial time devoted to other activities such as organizing and coordinating the first joint forum with HKEx and the FRC. Furthermore, some of the issues noted from reviews were very complex and significant additional time was spent in conducting research and consultations with panel members. After several consultations with panel members, two cases were referred to the Financial Reporting Standards Committee (the “FRSC”) to seek clarification in relation to the accounting treatment of the issues noted.

The chart below shows that there were similar results in respect of the initial reviews of financial statements carried out in 2011 and 2010. It is pleasing to note that no follow up action was needed for the majority of financial statements reviewed.
For the cases which required enquiries during 2010 and 2011 reviews, most were closed after one or two rounds of enquiries. In 2011, one case involving more significant departures from accounting standards was referred to the Compliance Department of the Institute for further consideration by the Professional Conduct Committee. It was confirmed in Council’s February 2012 meeting that the case would be referred to the FRC.

Another case involving potential non-compliance with an accounting standard was referred to the FRC for investigation. The investigation has been completed and the Institute is considering whether there is a need for follow up action.

Cooperation with the FRC and HKEx

The Institute, the FRC and HKEx carry out similar programmes of reviews of listed companies financial statements. In order to avoid duplication of reviews and so that members can gain most benefit from our programme, the Institute regularly communicates with the other two bodies. As mentioned earlier, the three bodies held a joint seminar in October 2011 to share observations noted from reviews of listed company financial statements. This joint event will become an annual feature.

Starting from 2011, the QAD, the FRC and HKEx have shared the review of the financial statements of “A+H” share and “H-share” companies, which are prepared under Chinese Accounting Standards for Business Enterprises under new HKEx rules.
Our findings

Practice review programme

This is the fifth year we have issued an annual report under the revised practice review programme. Many findings that we have covered in our previous reports continued to be identified in 2011 practice reviews, for example:

- practices had acquired “A Guide to Quality Control” issued by the Institute but had not tailored it to suit the circumstances of the Practice;
- inconsistencies between policies and procedures in Practice’s quality control manuals (“QCM”) and those actually applied or procedures set out in the QCM not implemented;
- a monitoring function had not been established or no reviews were carried out;
- monitoring reviews did not include a review of compliance with the firms’ quality control policies and procedures;
- no documentation to support the monitoring review;
- forms and checklists completed in a mechanistic manner without giving issues proper consideration e.g. client acceptance and continuance, audit planning and risk assessment and compliance work for regulated clients such as securities brokers and insurance brokers;
- inadequate audit evidence to support significant balances and related audit judgments;
- inadequate or insufficient audit documentation to evidence the audit work performed; and
- representation letters not tailored to the client’s situation or significant representations from management not included in written representation letters.

From our observation, practices which more commonly exhibited these deficiencies were mostly smaller firms. On more than one occasion we noted that a Practice introduced quality control policies and procedures, for the first time, just prior to the practice review in what appeared to be a reaction to the notification of review.

One of the main areas that smaller Practices seem to struggle with is documenting their audit work. As required by standards, auditors have to undertake sufficient audit work to satisfy themselves that there are no material misstatements in the financial statements. Unless auditors document the audit procedures they performed, it is difficult for us or other external reviewers to understand the nature and extent of audit procedures undertaken. It is also good practice management and risk management for practitioners to ensure that audit work is properly documented. When audit evidence obtained in previous years is relevant to the current year audit, relevant documents should be kept in a permanent file with proper cross referencing in the current year file.

The use of audit programmes is helpful in most audits but smaller Practices often place “complete” reliance on standard programmes and do not tailor them to be more “client-specific”. There is a tendency for staff to use a “tick-box” approach...
when completing programmes without any thought going into the sufficiency and appropriateness of the audit evidence being gathered. Some practitioners might believe that following each and every step in an audit programme will produce a “high” standard audit that will not be challenged by regulators. However, this is not necessarily the case if an auditor is unable to provide audit evidence to support work carried out other than a standard programme with simple “yes and no” answers.

Apart from the above, there were a number of key issues and concerns arising from our 2011 practice reviews which all Practices should be alert to:

1. **Independence – preparing accounting records and financial statements**

Instances were noted where some smaller Practices and sole practitioners were not aware of the independence requirements in the Code of Ethics (“Code”) when they provide non-assurance services to their audit clients. Therefore they did not go through the “threats and safeguards” process to ensure that threats are identified and reduced to an acceptable level by safeguards when needed. It is common for smaller Practices and sole practitioners to provide accounting and bookkeeping services to their audit clients. The QAD recognizes that practitioners are not restricted in providing services to their small audit private company clients under the Code, as long as they are mindful of the threats to independence and introduce appropriate safeguards to reduce those threats to an acceptable level. For example, it is well understood that the preparation of journal entries may create a self-review threat if practitioners were to subsequently audit their own work. However, when the journal entries are simple in nature e.g. to record depreciation, the self review threat would be insignificant because these entries do not involve the application of complex accounting standards. Consequently, no safeguards would be required.

On the other hand, when client’s transactions involve accounting issues which require significant judgment e.g. bad debt provision and inventory provision, the self-review threat would be significant and practitioners would need to document their assessment of the threat and conclusion on safeguards that are appropriate to eliminate the threat or reduce it to an acceptable level e.g. the need to arrange a staff / partner who is not a member of the audit team to do / review the work and no involvement in making management decisions for the client.

Practitioners are reminded to document the thought process in relation to their independence assessment on audit files.

2. **Professional skepticism**

Our findings continue to identify the need for Practices to ensure that partners and staff exercise appropriate professional skepticism, particularly in the key areas of audit judgment on valuation of assets and impairment of goodwill and other intangible assets. For instance, if client management prepared a cash flow forecast to support the view that no impairment was necessary, the audit team should perform audit work to ascertain the reasonableness of assumptions used in the forecast. We also came across situations where management
representations were the only audit evidence obtained to support conclusions that no impairment of assets such as goodwill and other intangibles was required. Over-reliance on management representations is another example of insufficient professional skepticism being applied in the conduct of audits. Practices should also be mindful when auditing “normal” account balances under unusual arrangements. For example, when a material bank balance is said to be held by an individual on behalf of a client, the Practice should assess whether there are internal controls to address the risk of misappropriation of assets. Another example is confirmation arrangements. Instances were noted where audit confirmations were sent and received through clients but practitioners did not assess the potential risk arising from the lack of confirmation control procedures and consider the need for further work.

Auditors are required to apply professional skepticism during the conduct of an audit. The exercise of a sufficient level of professional skepticism is important in determining an appropriate opinion. Lack of professional skepticism may result in an inappropriate audit opinion and potential exposure to disciplinary action or even litigation brought by individuals who rely on the financial statements. Practitioners and senior practice management are expected to play an important role in promoting the application of professional skepticism within their Practices.

3. **Subcontracting arrangements**

Another focus of practice review in 2011 was Practices’ control over the quality of work carried out by subcontractors e.g. whether practitioners were able to carry out a meaningful and appropriate review of audit work carried out by subcontractors. As mentioned in previous reports and forums, subcontracting arrangements allow access to flexible additional resources when needed and are acceptable, as long as practitioners are able to exercise appropriate control over the subcontractors’ work.

In a number of cases where audit clients had been introduced to Practices by subcontractors, unsatisfactory working arrangements were identified, for example:

- subcontractors had carried out most / all of the audit work before approaching Practices to request their involvement;
- all audit files were retained by subcontractors;
- fees were negotiated and fee notes were issued by subcontractors;
- nominal fees were received by Practices for referred engagements;
- all contact with clients was by subcontractors who restricted Practices’ access to clients; or
- subcontractors did not respond to review queries raised by Practices and did not allow Practices to contact clients to clear queries.

The QAD had serious concerns with such arrangements where Practices were unable to exercise proper control of subcontractors and their work. Actions taken against Practices involved in such arrangements have included directing them to terminate the subcontracting arrangements or to resign as auditors of referred
engagements. There was close monitoring by the QAD of remedial action taken by Practices.

Practices are reminded that they retain ultimate responsibility for the audit work on subcontracted engagements and if they are unable to control the subcontractors and their work, they should not accept or continue this type of arrangement. Practices must bear in mind that the use of a subcontractor is not a defense when “problems” occur with the audit which could potentially cause a loss of reputation, financial loss or even lead to disciplinary sanctions.

4. **Engagement quality control review**

Most Practices are well aware that all listed company audits require an engagement quality control ("EQC") review. However, it appears that EQC review is viewed by some Practices primarily as a compliance task, and they did not devote sufficient time to the review. Little evidence of EQC review was retained on the audit files. All Practices should appreciate the role of EQC reviewer who ensures all appropriate audit work is carried out and properly recorded before issue of opinion. Practices with listed clients are reminded to assign personnel with appropriate experience and authority to act as EQC reviewer on audits of financial statements of listed clients. Instances were identified where the role of EQC reviewer was delegated to junior managers who may lack the required experience to perform an effective review and may shy away from challenging audit partners when they encounter “issues”.

5. **Audit issues on mining industry clients**

There are an increasing number of Practices that have audit clients with principal or major activities in the mining industry. The QAD reviewed a number of this sort of audit engagement in 2011. The more common issues identified are set out below:

i. **Exploration and evaluation assets**

   (a) Classification
   Some Practices were not aware of the requirements in HKFRS 6 *Exploration for and Evaluation of Mineral Resources* that exploration and evaluation assets (“E&E assets”) e.g. cost of acquiring exploration rights, topographical and geological surveys, exploratory drilling, should no longer be classified as such when technical feasibility and commercial viability of extracting mineral resources becomes demonstrable e.g. mines have commenced production and are generating revenue. Assets should then be classified as tangible or intangible according to their nature e.g. drilling rigs as plant and equipment and drilling rights as intangible assets.

   (b) Impairment
   HKFRS 6 requires a mining entity to assess exploration and evaluation assets for impairment when “facts and circumstances” suggest that the carrying amount of an asset may exceed its recoverable amount. Such “facts and circumstances” could include no plan or budget for further exploration or evaluation expenditure in the area, the entity’s right to explore the area has expired or will expire in the near future with no concrete
evidence to show management's expectation of renewal. Where such circumstances had occurred the financial reporting implications were not always recognized by client or auditor. The application of impairment requirements is important for mining entities that have recognized all exploration and evaluation expenditure as an asset as they usually carry significant amounts on the balance sheet in respect of projects for which the outcome is highly uncertain.

ii. Laws and regulations

National laws related to mining activities and entities can apply across the full spectrum of a mining cycle, from initial ownership and access rights for exploration, through mining and processing, to the use of the end product, disposal of waste materials or restoration requirements. For instance,

- obligations for environmental restoration and rehabilitation generally arise when the asset is installed or the ground environment is disturbed at the production location;
- mineral exploration licences are granted for an initial period of a number of years. Generally holders may apply for a licence extension subject to payment of an annual licence fee and fulfilling a minimum exploration expenditure requirement. Failure to meet these requirements may result in licence cancellation by the authorities; or
- local regulation prohibits mineral exploration and mining in areas adjacent to rivers and lakes and forest areas to reduce impact on the environment of mining operations.

Instances were identified where auditors did not take into consideration local mining legislation and environmental law and regulations which might result in potential audit risk e.g. asset impairment, potential litigation and provision for compensation. A mining business is generally subject to extensive government regulations, policies and controls. Failure to comply with relevant laws and regulations in any mine development and coal production project may adversely affect the clients’ business.

iii. Goodwill impairment

It was common to see substantial amounts of goodwill arising from acquisitions of mining businesses. Annual reports often disclosed that goodwill was properly assessed for impairment. However, instances were identified where evidence of such assessment was lacking in the audit working papers. In a number of cases, only a copy of the client's cash flow projection was filed with minimal work, such as casting and recalculation performed by junior staff. There was no work performed to review the appropriateness of underlying basis and assumptions, such as production volume, projection period, discount rate, forecast revenue and cost. Practices should exercise professional skepticism to appropriately challenge their clients on the appropriateness
of assumptions and address the risk of manipulation of forecasts.

iv. Reliance on professional valuation

The QAD continued to identify circumstances where Practices did not evaluate an expert’s work as required under HKSA 620 (Clarified) *Using the Work of an Expert* e.g. assessment of valuers’ independence and competence, review of the appropriateness of valuation methods and assumptions used and review of the relevance, completeness, and accuracy of source data. In some cases, Practices did not consider whether they needed to undertake any additional audit procedures in respect of disclaimers made by valuers in their reports before they placed reliance on them. For example, Practices should consider obtaining audit evidence of ownership of assets when valuers were unable to verify title to assets. Practices should not assume the scope of work of a valuer remained the same as in previous years when the work had been performed by the same valuer. Practices should fully understand valuers’ scope of work and disclaimers made, communicate with valuers and follow up on queries when needed.

Smaller Practices which handle audits of mining businesses should carefully consider whether they have the appropriate resources, expertise and involvement to undertake audits to the required standards e.g. practitioners and their audit staff should keep abreast of current professional standards and obtain a thorough understanding of the key features of the mining industry.

6. Group audits

HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* contains expanded requirements and guidelines for group auditors. The changes increase responsibility of group auditors and the group audit partner for direction, supervision and performance of the whole group audit engagement. The following are some issues identified:

- the group audit team did not prepare an analysis of components to identify those that are significant and plan for work to be performed on component financial information. There may be insufficient audit evidence to support the group audit opinion if a significant component was not properly identified and appropriate audit work planned and carried out;
- communications with component auditor not timely or insufficient indicating that the group auditor did not direct and supervise the audit work of the component auditor;
- failure or inability to get involved in the work of the component auditor on a significant component to the extent necessary to obtain sufficient appropriate audit evidence to support the group audit opinion;
- in cases where the auditor of a significant component did not fully cooperate, the group auditor did not carry out additional procedures, e.g. directly auditing the financial information of the component; and
- the audit of a significant component performed by component auditor was completed later than the group’s audit report date.
In order to prevent the above issues, the group audit partner should evaluate whether the group audit team will be able to be involved in the work of component auditors to the extent necessary to obtain sufficient appropriate audit evidence at an early stage, e.g. during the acceptance and continuance process. Where necessary, terms in the letter of engagement for the group audit may cover matters such as free communication between the group auditor and the component auditors, permission to access component information, component management and auditors and to perform work on components’ financial information, or request the component auditors to do so. If it is foreseen that the component auditor may not fully cooperate with the group auditor or the timing of the component audit does not fit with the group audit, the group audit team should communicate with group management and request group management’s assistance in resolving the issues. Group management should be able to influence component management to impose responsibility on the component auditor to cooperate with the group audit team. If other satisfactory arrangements are not possible, the group auditor may need to arrange for the audit of the significant component to be carried out by the group audit team. If sufficient appropriate audit evidence cannot be obtained on the significant component, the group auditor should consider modifying its audit opinion on the group financial statements.

Practices are also reminded to refer to guidance in the Hong Kong Companies Ordinance on communication with the component auditor set out in Appendix 6 to HKSA 600. This states that the subsidiary (component) auditor has a statutory duty to provide information and explanations to the holding company (group) auditor for the purpose of performing the group audit if both the holding company and subsidiary company are incorporated in Hong Kong. If the subsidiary is not incorporated in Hong Kong, the holding company has a duty to take all reasonable steps open to it to obtain such information and explanation from the subsidiary as the group audit team may require for group audit purposes.

7. Audit of term loans

The classification of a term loan depends on whether or not the borrower has an unconditional right to defer payment for at least 12 months after the reporting period. Instances were noted where entities classified portions of term loans with repayment-on-demand clause as current liabilities on the basis that this was in line with repayment terms. Practices concurred with the classification without obtaining sufficient audit evidence to support the treatment. Some Practices were not aware of the requirements of HKAS 1 (Revised) Presentation of Financial Statements or clarifications highlighted in HK Interpretation 5 Presentation of Financial Statements – Classification by the Borrower of a Term Loan that Contains a Repayment on Demand Clause that requires loans with repayment-on-demand clauses to be classified as current liabilities. Others agreed with clients’ requests that there should be no change in policy for classification of term loans on the basis of management representations that the lender
will not exercise its rights within the 12 months after the reporting date. This explanation is not relevant in the context of paragraph 69 of HKAS 1 (Revised).

Should a client classify term loans which contain repayment-on-demand clauses as non-current liabilities, Practices should obtain relevant evidence to support this. Such evidence may take the form of modification by the bank of loan conditions or a legally enforceable comfort letter indicating that loans will not be called within the next 12 months. Practices should consider modifying the auditor's report if the financial statements are not free from material misstatements or sufficient and appropriate evidence cannot be obtained.

8. Management representations and communication with management

Auditors have a responsibility to obtain written representations from management and, where appropriate, those charged with governance in an audit of financial statements. A management representation letter is used to support other audit evidence relevant to the financial statements. It also re-emphasises management responsibility for preparation of the financial statements and for completeness of information provided to the auditor. This will encourage management to focus on the preparation of good quality financial statements. Practices should ensure that written representations are given by persons with appropriate responsibilities for the financial statements and knowledge of the matters concerned. In some instances, Practices did not obtain a representation letter from management or simply requested management to sign on a standardized representation letter without any tailoring. Written representations are part of audit evidence and representation letters should be tailored to a client’s situation and include all significant representations from management that are relied on by the auditor.

Auditors also need to communicate with management by way of a management letter, especially when significant deficiencies in internal control are identified. Details of communication requirements are set out in HKSA 265 (Clarified) Communicating Deficiencies in Internal Control to Those Charged with Governance and Management. Practices are reminded that communication with management on deficiencies in internal control is important to ensure that management are made aware of deficiencies which merit their attention and action.
**Professional standards monitoring programme**

This section presents a summary of the more significant or regular observations identified by reviews of published financial statements. Our aim is to provide constructive insights on the application of financial reporting standards in the preparation of future financial statements.

The first part summarizes common financial reporting issues which we have also come across in our reviews in previous years. That matters remain as common observations suggests that there is a lack of understanding of the standards. Our comments will focus on the key requirements of accounting standards that relate to the identified deficiencies.

The second part discusses other topical or newly arising critical issues, including our observations in relation to initial application of new or revised standards.

**Section I – Recurring issues**

This section will focus on recurring findings in respect of HKAS 36 *Impairment of Assets*,HKAS 1 (Revised) *Presentation of Financial Statements*, HKFRS 7 *Financial Instruments: Disclosures* and HKFRS 8 *Operating Segments*. These standards warrant special attention when preparing or auditing financial statements.

1. **Impairment of Assets**

   Extensive disclosures are required by HKAS 36 to support impairment assessments. The information required includes key assumptions used in determining recoverable amount of assets; sensitivity analysis of how possible changes in key assumptions would impact the recoverable amount; and events and circumstances that led to “recognition” or “reversal” of the impairment loss. Disclosures should be fact-specific, clear and sufficient to allow users to understand management’s judgments. Because of disclosure omissions, questions were frequently raised about the validity and reasonableness of assumptions used by management in impairment testing and the adequacy of disclosures. Common issues and disclosure deficiencies are summarized below:

   i. **Identifying impairment indicators**

   An entity shall consider at the end of each reporting period whether any indicator of impairment exists, and estimate the recoverable amount of the asset if any indications exists. However if an asset or cash-generating unit (“CGU”) is or contains an intangible asset with an indefinite useful life, or an intangible asset that is not yet available for use, or goodwill acquired in a business combination, such asset or CGU needs to be tested for impairment at least once a year no matter whether an impairment indicator exists or not.

   A number of entities reported continuous losses and negative net operating cash flows which might be an indicator that assets are impaired. However, it was often the case that no impairment was recognized by management and no explanation was given to explain why no impairment was required. Management judgements and key assumptions applied in impairment testing should be disclosed.

   Paragraph 12 of HKAS 36 provides a list of examples of external and internal indicators of impairment.
ii. **Determining a CGU**

HKAS 36 requires that a CGU is the “smallest” identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

In some financial statements reviewed there was information that suggested that CGUs might not be properly identified. Factors such as how cash flows are managed by the entity, whether there is an active market for the assets and how the assets work interdependently to generate cash flows should be considered carefully when identifying CGUs. Illustrative Example 1 appended to HKAS 36 includes examples of identification of CGUs.

iii. **Allocating goodwill to CGUs**

HKAS 36 further requires that goodwill shall be allocated to a CGU or group of CGUs which represent the lowest level within the entity at which goodwill is monitored for internal management purposes and not larger than an operating segment as defined by HKFRS 8 paragraph 5 before aggregation.

Some companies allocated goodwill at “subsidiary” level where there are more than one business operation and performance for each business operation was reported separately to the chief operating decision maker. This is not consistent with HKAS 36 requirements.

It is important to properly identify the CGU at the lowest level within the entity. Inappropriate identification could result in failure to recognize an impairment loss, for example in situations where some aggregated units contain sufficient cushions to offset the impairment losses of other units.

iv. **Recoverable amount and carrying amount of CGUs**

HKAS 36 requires that carrying amount and recoverable amount of CGUs shall be consistently determined.

The carrying amount of a CGU includes only “assets” that can be attributed directly, or allocated on a reasonable and consistent basis and will generate future cash inflows used in determining the CGU’s value in use. It does not include the carrying amount of any recognized “liability” such as trade payables and other provisions, unless the recoverable amount of the CGU cannot be determined without taking it into account. This is because value in use and fair value less cost to sell are determined excluding cash flows that relate to assets that are not part of the CGU and liabilities that have been recognized. However, it is accepted in HKAS 36 that for practical reasons, an entity might determine the recoverable amount of the CGU after consideration of assets that are not part of the CGU (e.g. receivables and other financial assets) and liabilities that have been recognized (e.g. trade payables and other provisions). In this case, the carrying amount of the CGU must be calculated on the same basis. HKAS 36 paragraphs 74 to 79 provides the relevant guidance.
The QAD encountered a scenario where assets and liabilities included in the carrying amount of the CGU were not consistent with those included in the calculation of the recoverable amount. For example, receipts from trade debtors were included in cash flows when calculating value in use, but were not included in the carrying amount of the CGU. A potential impairment could be hidden if the carrying amount and recoverable amount of the CGU are not determined in a consistent and comparable basis.

v. Measuring recoverable amounts

The recoverable amount of an asset or CGU shall be measured at the higher of its value in use or fair value less cost to sell. Determining the recoverable amount of an asset or CGU often gives rise to valuation issues.

Value in use is the present value of future cash flows expected to be derived from an asset or CGU. Calculating the value in use involves estimating the future cash inflows and outflows from continuing use of the asset and from its ultimate disposal. The cash flows are discounted to present value by applying an appropriate discount rate.

(a) Estimation of future cash flows

HKAS 36 specifically states that future cash flows shall be estimated for an asset in its “current condition” over its remaining useful life. Therefore, future cash flows that are expected to arise from a future restructuring to which an entity is not yet committed or future cash flows relating to plans for enhancing the performance of a CGU are excluded. A restructuring programme is not committed unless the entity can provide for the costs under HKAS 37 Provision, Contingent Liabilities and Contingent Assets.

HKAS 36 also states that estimated future cash flows shall not include cash flows from financing activities and income taxes.

(b) Basis for estimation of cash flows

HKAS 36 requires that entities shall ensure the assumptions on which their cash flow projections are based are reasonable and supportable. In this respect, the reasonableness of the assumptions should be assessed by examining the causes of differences between past cash flow projections and actual cash flows. In addition, entities shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

Cash flows projections should be based on the most recent budgets and forecasts for a maximum of five years. HKAS 36 explicitly states that detailed, explicit and reliable financial budgets or forecasts of future cash flows for periods longer than five years are generally not available unless the entity can demonstrate its ability, based on past experience, to accurately forecast cash flows for a period beyond five years.
Therefore, cash flows for periods longer than five years are generally extrapolated from earlier budgets using a steady or declining growth rate, unless an increasing rate can be justified. This growth rate shall not exceed the long-term average growth rate for products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

Enquiries were frequently raised on how auditors were satisfied with assumptions used by management in cash flows projections. The expected growth rate of the business used in cash flow projections was often not consistent with the performance of the business as disclosed in segment information. There were instances where the same or a higher growth rate than the previous year was used by management which was inconsistent with the actual performance of the business where continuous losses were incurred.

Many sources of market information are available for most market sectors and entities should consider them as external evidence to support growth assumptions. Prior year assumptions might not be applicable in the current year as the economic environment changes over time. Up-to-date market information for similar industries should be taken into account in determining assumptions for impairment assessment.

(c) Discount rate

HKAS 36 states that discount rate is a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset. The rate is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset.

The QAD noted that discount rates used were not always reasonable. For instance, the rate used was lower or the same as the bank borrowing rate with no adjustments made to reflect specific risks such as currency, country and price risks; or the discount rate used was the same as the previous year despite substantial changes in the economic situation faced by the entity. Generally it would not be appropriate to use the same discount rate for different CGUs as the discount rate should reflect specific risks of the asset or CGU.

If an asset-specific rate is not available from the market, an entity can use surrogates to estimate the discount rate. HKAS 36 suggests that the entity’s weighted average cost of capital (“WACC”), incremental borrowing rate and other market borrowing rates can be used as a starting point. However, this is only a starting point and adjustments should be made in order to determine an appropriate discount rate, for example, bank borrowing rate normally includes an element of default risk for the entity as a whole which is not relevant in assessing returns expected from the assets. WACC, which is commonly used in practice,
is a post-tax rate and should be adjusted before being used as the discount rate. Appendix A of HKAS 36 provides additional guidance on estimating discount rates. Key considerations are that the discount rate used should be appropriate, sensible and justifiable as it is a crucial part of the impairment testing process.

vi. Disclosures

The following disclosures were often found to be superficial, incomprehensible or missing:

• descriptions of key assumptions used in determining recoverable amounts of assets or CGUs. Key assumptions are those to which the asset or CGU’s recoverable amount is the most sensitive and are not necessarily restricted to only discount rate and growth rate;

• explanation of why management has projected cash flows based on a financial budget covering a period greater than five years;

• description of growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and justification for using any growth rate that exceeds the long-term average growth rate for the products;

• explanation of substantial changes in key assumptions compared to previous years;

• additional disclosures if a reasonably possible change in key assumptions would cause the CGU’s carrying amount to exceed its recoverable amount. The required additional disclosures are i) the amount by which the recoverable amount exceeds the carrying amount; ii) the value assigned to the key assumptions used in the sensitivity analysis; and iii) the amount by which the value assigned to key assumptions must change in order for the CGU’s recoverable amount to be equal to its carrying amount;

• description of the basis for determining the fair value if fair value less costs to sell is not determined using an observable market price for the CGU; and

• events and circumstances that led to “recognition” or “reversal” of impairment losses.

Disclosures in relation to impairment assessment often appeared to be superficial and of little value to users of the financial statements. Full and precise disclosures are required to increase the level of transparency in management judgments applied in impairment tests.

2. Presentation of financial statements

The following information was often not disclosed in financial statements:

• nature, terms and conditions (as appropriate) of significant items or transactions and description of the nature and purpose of each reserve within equity, e.g. capital reserve, capital redemption reserve and contributed surplus;

• nature, amount and reason for reclassifications of comparative amounts;
• missing, inappropriate or boilerplate accounting policies and note disclosures;

• description of the entity's objectives, policies and processes for managing capital;

• summary quantitative data on capital management;

• critical accounting estimates and judgements made by management; and

• name of parent and ultimate parent of a listed entity.

3. Financial Instruments: Disclosures

HKFRS 7 disclosure is an area of financial reporting that we comment on regularly. Disclosures are often omitted or addressed by "boilerplate" wording without tailoring to the entity's circumstances or contradict information disclosed elsewhere in the financial statements. The following information is frequently omitted or disclosed in a way that is confusing:

• disclosures for all financial instruments of an entity and not only trade receivables and trade payables;

• disclosures for financial instruments at the company level such as amount due from subsidiaries and related companies;

• when a valuation technique is used, the methods and assumptions applied in determining fair values of each class of financial assets or financial liabilities;

• disclosures on objectives, policies and processes for managing currency risk, credit risk and liquidity risk are boilerplate and not consistent with the entity's circumstances. For example, the entity has one or two major customers but the disclosure states that the entity has no concentration of credit risk; and the entity has trade receivables denominated in various foreign currencies like Euro, RMB, USD but disclosed that it was only exposed to foreign currency risk arising from RMB;

• an analysis of financial assets that are individually determined to be impaired as at the reporting date, including the factors considered in determining that they are impaired;

• credit quality of financial assets that are neither past due nor impaired;

• maximum risk exposure to credit risk including financial guarantees;

• maturity analysis for non-derivative financial liabilities omits the maximum amount of issued guarantees that could be called. Entities should ensure that both non-derivative and derivative financial liabilities are included in the maturity analyses as required by HKFRS 7 paragraph 39(a) and (b). Derivative financial liabilities are included in the maturity analysis if their contractual maturities are essential for an understanding of the timing of the cash flows; and

• disclosures about how entities manage their liquidity risk exposure such as information on how they comply with loan covenants and whether they have committed but unused banking facilities.

It is important that entities provide full and transparent disclosures about their financial instruments and their usage. This can be achieved through a better understanding
of HKFRS 7 and its Appendix B disclosure requirements.

4. Operating segments

The core principle of HKFRS 8 is that an entity should disclose information to enable users of financial statements to evaluate the nature and financial effects of the types of business activities in which it engages and the economic environment in which it operates. Full and precise disclosures regarding operating segments are essential to achieve the objective of HKFRS 8. However, disclosure deficiencies are repeatedly identified, such as:

- segment disclosures were not consistent with management commentary such as directors’ report and management discussion and analysis (“MD&A”), for example, three segments were disclosed in the segment information note while the business overview in the MD&A included five business operations;
- no clear description of the identity of the chief operating decision maker;
- no description of factors used to identify reportable segments and reasons for aggregation of segments;
- material reconciling items not separately identified and described;
- no description of the nature of differences between measurements for segment purposes and for the entity as a whole;
- no description of the basis of accounting for any transactions between segments; and
- entity-wide disclosures such as the fact that revenue from a single customer amounted to 10% or more of the entity’s revenue or respective contribution of external revenue from the entity’s country of domicile and foreign countries were not adequate.

It is not only important for entities to provide the full disclosures required by standards but also to ensure it is quality information that is useful to users of the financial statements.

Section II – Topical issues

Initial application of new or revised financial reporting standards

Of the new or revised standards that were first effective for annual periods beginning on or after 1 January 2010, the QAD considers that HKFRS 3 (Revised) Business Combinations, HKAS 27 (Revised) Consolidated and Separate Financial Statements, Amendments to HKAS 17 Leases and Hong Kong Interpretation 5 might be more relevant and applicable to many listed companies. The following are the key observations from reviews.

1. HKFRS 3 (Revised) and HKAS 27 (Revised)

There were significant changes in the above two standards in relation to accounting for business combinations and changes in ownership interests. Application was generally well managed but there were some problems in the areas below.

i. Key observations on application of HKFRS 3 (Revised)

(a) New definition of business

In deciding how to account for a transaction, the first step is to determine whether it is a business combination.
Therefore the acquirer needs to identify whether the acquiree meets the definition of a business. Under the new definition set out in Appendix B of the standard, inputs and process are the two basic components that make up a business. Although outputs are usually present, they are not a required component of a business. For example, entities with only start-up activities or those that are at an under development stage can be a business.

The term “process” in the standard refers to “Any system, standard, protocol, convention or rule that when applied to inputs, creates or has the ability to create outputs. Examples include strategic management, operations and resource management…. Accounting, billing, payroll and similar administrative systems typically are not processes used to create outputs“ (underline added). In response to some enquiries the auditors explained that administrative functions such as accounting and billing are part of the processes that constitute a business. This is not the case as such functions do not directly relate to operating activities that enable the entity to generate revenue.

To justify the existence of a “process” which has the ability to create outputs, the acquirer may need to consider whether personnel are involved in carrying out the “process” and if so, whether the personnel involved are the workforce of the acquiree. If there are no personnel involved or they do not come from the acquiree, the acquisition might not be a business combination as there is no “process” involved in the acquisition.

The acquirer should consider all relevant factors and apply judgement to determine whether the transaction is a business combination. Where appropriate, the acquirer should follow HKAS 1 (Revised) to disclose the basis of judgement reached by management. If the transaction does not meet the criteria for acquisition of a business it should be accounted for as an asset acquisition.

(b) Determination of acquisition date

The acquisition date is the date on which the acquirer obtains “control” of the acquiree, i.e. the date from which the acquirer has the power to govern financial and operating policies of the acquiree so as to obtain benefits from its activities.

In some instances the timing of passing of control of the acquiree to the acquirer was unclear. For instance, disclosures stated that in the event that profits of the subsidiary did not meet target level after a specified period (e.g. one year), the vendor would purchase back the subsidiary at the original consideration. Furthermore, the vendor would remain involved in management of the subsidiary during the specified period after consideration was paid. That an independent vendor is willing to provide such a guarantee to the buyer of the acquired company and continues to have involvement in the financing and operating decisions of the subsidiary raises doubts whether the acquisition has in fact been completed and suggests that the acquirer, in substance, was allowed to re-consider its acquisition decision during the specified period. The key for determination
of acquisition date is to establish when the control of and the related risks and rewards associated with the subsidiary have been passed to the acquirer.

(c) Bargain purchase

A “gain” on a business combination might happen because the acquirer has not identified and recognized all identifiable assets and liabilities at fair value on the acquisition date. Alternatively as suggested in HKFRS 3 (Revised) paragraph 35, a “gain” may be recognized because of the recognition or measurement exceptions for particular items discussed in HKFRS 3 (Revised) paragraphs 22 to 31. Such exceptions may also change the amount of a recognized gain on a bargain purchase.

Before recognizing a gain on bargain purchase, the acquirer shall “reassess” whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. The acquirer should ensure that the measurements are appropriate and reflect management’s consideration of all available information at the acquisition date. References should be made to HKFRS 3 (Revised) paragraph 36 for guidance.

If it is justified that the transaction is a bargain purchase after performing the steps required under HKFRS 3 (Revised) paragraph 36 as mentioned above, entities shall disclose the circumstances that give rise to the bargain purchase. The QAD occasionally notes that such disclosures are not made.

(d) Disclosure deficiencies

HKFRS 3 (Revised) Appendix B paragraphs 64 to 67 sets out disclosure requirements for business combinations. Relevant disclosures are also required for business combinations that occur after the end of the reporting period but before the financial statements are authorized for issue. Disclosures that are often omitted include:

- method of determining fair value of equity instruments which form part of the consideration;
- gross contractual amounts receivable for acquired receivables;
- total amount of goodwill that is expected to be deductible for tax purposes;
- amount and treatment of acquisition-related costs;
- measurement basis for non-controlling interest; and
- reasons why the transaction has resulted in goodwill or bargain purchase.

ii. Key observations on application of HKAS 27 (Revised)

Amendments to HKAS 27 mainly relate to changes in accounting for non-controlling interests and the loss of control of a subsidiary. There are no significant observations in relation to application of
Careful judgement and consideration of all facts and circumstances is vital before concluding whether “de facto control” is present. All relevant facts, including any factors which may prevent the entity from governing (not just participating in) financial and operating policies of the investee, should be analysed and considered.

2. Amendments to HKAS 17 Leases

Under the previous version of HKAS 17, a lease of land which had an indefinite economic life was normally classified as an operating lease, unless title was expected to pass to the lessee by the end of lease term. As a result of the amendments, this guidance has been removed and leases of land should be classified as either operating leases or finance leases using the general principles of HKAS 17. Therefore a land lease is classified as a finance lease if the lease transfers substantially all risks and rewards incidental to ownership to the lessee.

In applying the amended HKAS 17, an entity should reassess its classification of leases with respect to unexpired leasehold land at the beginning of the reporting period in accordance with the transitional provision of the amendments.

Some entities changed the classification of land interests from operating lease to finance lease during the year but provided no disclosures to explain how the requirements and the transitional provision of the amendments were followed to support the reclassification. For
example, it was not clear what factors (HKAS 17 paragraph 10) the entity had considered in concluding that the land interest was a finance lease. Furthermore, as legal requirements vary in different jurisdictions that might affect the classification of land lease, the jurisdiction of the places in which the land was located should be taken into account in classifying leases. However, in some cases the location of the land interests held by the entity and management assessment were not disclosed.

In other instances, an entity had land leases in both Hong Kong and Mainland China but no disclosure was made to explain whether the amendments had a similar or different impact on the classification of the relevant land lease.

Questions and Answers developed by the Institute to facilitate understanding of the amendments to HKAS 17 are available at the following link:


3. **Hong Kong Interpretation 5**

Hong Kong Interpretation 5 is a clarification of an existing standard (HKAS 1) and had immediate effect upon issue in November 2010. The Interpretation requires that amounts repayable under a loan agreement which includes a clause that gives the lender the unconditional right to call the loan at any time shall be classified by the borrower as current in its statement of financial position. During its practice reviews, the Institute identified audit weaknesses in relation to application of the Interpretation. Please refer to the practice review section of this report for details. Financial reporting matters were also identified by reviews under the professional standards monitoring programme.

Entities shall assess whether the Interpretation has effect on their current period or any prior period financial statements or might have an effect on those of future periods. If that is the case, entities are required to disclose information required under paragraph 28 of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* such as the title of the Interpretation, the nature of changes in the accounting policy and the effects on the financial statements.

Instances were found where entities have classified significant borrowings as non-current liabilities and have not clearly disclosed the terms of these borrowings. In view of the significance of the borrowings, enquiries were raised with the auditors to ask how they were satisfied that relevant borrowings were properly classified.

Paragraphs 13 and 14 of the Interpretation also emphasize that entities shall disclose relevant information as required by HKFRS 7 in order to explain to users of financial statements the extent to which management considers that repayment on demand clauses affect their liquidity risk.

Materials have been developed to facilitate understanding of the standards, which are available at the following links:
Other topical financial reporting issues

1. **Revenue recognition**

HKAS 18 *Revenue* contains general principles for revenue recognition that apply to all entities. In practice, determining an appropriate accounting policy sometimes is difficult and requires judgement with consideration of all facts and circumstances that are relevant to the transactions. Practical issues in relation to revenue recognition for multiple deliverables were discussed in QAD 2009 annual report (http://www.hkicpa.org.hk/file/media/section6_standards/quality_assurance/2009/qa-report.pdf). Other practical issues that have arisen during the reviews are as follows:

   i. **Principal versus agent**

   HKAS 18 requires that revenue includes only “gross” inflows of economic benefits received and receivable by the entity on its “own account”. In an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. Amounts collected on behalf of the principal are not revenue. Revenue is the amount of commission.

   Disclosures in some financial statements that suggested revenue was recognized on a gross basis were not consistent with the nature of the entity's business. For example in a travel agency business, segment disclosures showed that a small profit margin was derived from sales of air tickets and provision of hotel booking services and therefore revenue appeared to be recognized on a gross basis. However as a travel agent does not bear the inventory risk of air tickets, which is generally the responsibility of airline companies, revenue recognized by the travel agent should only be its commission.

   The substance of transactions and the risks and responsibilities of the entity in the transactions are essential in determining whether the entity is acting as agent or principal. HKAS 18 Illustrative Example 21 provides guidance.

   ii. **Reimbursement or collection on behalf of other party**

   HKAS 18 states that amounts collected on behalf of third parties are not economic benefits which flow to the entity and do not result in increases in equity. Therefore they are excluded from revenue.

   Amounts received on behalf of third parties should be treated as a payable balance until settled and revenue and expenses should not be grossed up. Care must be
taken to distinguish amounts received from customers in exchange for goods or services and amounts received on behalf of third parties from customers. Reimbursements of amounts paid on behalf of customers should be recognized as receivables until recovered and revenues and expenses should not be grossed up.

In one case “reimbursement of expenses” was described as revenue in the financial statements. Due to lack of information about the transaction, it was unclear whether reimbursement of expenses met the definition of revenue under the circumstances of the entity. Entities should consider all relevant facts and circumstances in determining whether amounts received from other parties are revenues and ensure that disclosures do not confuse users.

iii. Warranty obligations

It is common practice for an entity to provide a warranty on products sold. It is often unclear how warranty obligations are accounted for and whether it has an impact on revenue recognition.

As required by HKAS 18 paragraph 13, an entity should assess whether a single transaction contains separately identifiable components. Therefore when a product is sold subject to warranty, the seller should assess whether the warranty represents a separable component of the transaction. For example, in practice, the seller may sell an “extended warranty” to the buyer to extend the standard warranty period provided by the manufacturer. In this case, the transaction might in substance contain sales of two products (i.e. “the product with standard warranty provided by the manufacturer” and the “extended warranty”). Revenue from the sale should be allocated to the two components in this case and the portion attributable to the extended warranty should be shown as “deferred income” in the statement of financial position. The amount will subsequently be amortized to profit or loss as revenue over the extended warranty period.

If the entity determines that (a) the warranty is not a separate element, (b) any costs of honoring the warranty can be measured reliably, and (c) all the other criteria set out in HKAS 18 paragraph 14 have been met, then the full consideration should be recognized as revenue, and a corresponding “provision for warranty costs” should be recognized in accordance with HKAS 18 paragraph 19. However, if the warranty costs cannot be estimated reliably, then the whole transaction fails HKAS 18 paragraph 14(e) and revenue should not be recognized until the related warranty costs have been identified, which may not be until the end of the warranty period. Similarly, there may be other criteria in paragraph 14 which may not be met until the end of the warranty period and which therefore cause revenue to be deferred, as indicated in HKAS 18 paragraph 16.

iv. Revenue recognition policy and related disclosures

In some financial statements the accounting policy and related disclosures for revenue
recognition were not clear. The following are some examples:

- The accounting policy was general with insufficient information provided to enable users to understand the nature of revenue earned by the entity and whether the accounting used is in accordance with HKAS 18. In one case, it was disclosed that the entity engaged in the magazine and advertising business but another disclosure mentioned that the entity paid significant deposits to airline companies in relation to advertising services. In view of the lack of clarity about the role and responsibilities of the entity, it is not clear whether it was acting as an advertising principal or agent.

- In another example the entity rendered “development and integration services” to customers. There was no clear explanation of revenue recognition policy for development and integration services, in particular whether the accounting treatment follows HKAS 11 Construction Contracts or HKAS 18.

- The stated policy for revenue recognition was not entirely consistent with other information in the financial statements. This may have been because the preparers of the financial statements made reference to various sample financial statements published by larger firms but did not tailor the disclosures to their own circumstances.

- The description of a business arrangement was unclear, raising doubts on the timing of revenue recognition. A typical example relates to property sales. Disclosures mentioned that a buy-back arrangement was entered into by the reporting entity in favour of banks to secure mortgage loan facilities granted to buyers of the entity's properties held for sale. The entity was responsible for repayment of outstanding mortgage loans and accrued interest and penalties if the buyer defaulted in payments. Due to lack of information on the buy-back arrangement, it was not clear whether the entity has given sufficient consideration to the transfer of risks and rewards of properties before revenue was recognized.

2. Earnings per share (“EPS”)

EPS is an important measure in the analysis of financial statements and enables users to compare the performance of different entities. The following circumstances were identified in reviews of financial statements:

i. Impact of subsequent events on EPS calculation

HKAS 33 Earnings Per Share paragraph 26 requires that the number of shares used in the EPS calculation shall be adjusted for any transaction, other than the conversion of potential ordinary shares, that changes the number of shares outstanding without a corresponding change in resources. Paragraph 64 further requires that this applies for transactions that happen after the year end but before approval of financial statements.
In one example, subsequent to the year end the shareholders of the entity resolved to consolidate the share capital into a smaller number of shares. The entity had not taken into account the subsequent share consolidation in calculating EPS. As required by HKAS 33, EPS should be calculated based on the “new” number of shares for “all” periods presented in the financial statements given that consolidation of shares normally does not result in corresponding change in resources of the entity. Retrospective adjustments to the EPS for prior periods is required.

In addition to share consolidation, HKAS 33 paragraph 64 set outs other scenarios involving a change in the number of shares (i.e. capitalization, bonus issue or share split) where the entity should adjust EPS if the transactions do not change the resources of the entity.

**ii. Calculation of the weighted average number of shares as denominator for the EPS calculation**

HKAS 33 paragraph 19 states that for calculating basic EPS, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period. Paragraph 20 further states that the time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period.

In some instances the denominator used by the entity for EPS calculation (the number of ordinary shares) for the current year included new ordinary shares issued during the year without taking into account the time weighting factor.

Shares are included in the weighted average calculation from the date consideration is receivable (which is generally the date of their issue). HKAS 33 paragraph 21 provides examples illustrating the timing of inclusion of ordinary shares in the weighted average calculation. The timing of the inclusion of ordinary shares is determined by the terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

**iii. Calculation of diluted earnings per share**

HKAS 33 provides guidance on how to calculate diluted EPS. HKAS 33 paragraph 5 defines “dilution” as a “reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions”. In the diluted EPS calculation, dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or if later, the date of issue of potential ordinary shares (HKAS 33 paragraph 36). Anti-dilutive potential ordinary shares are excluded. Therefore an entity should follow procedures in paragraph 44 to identify all potential dilutive ordinary shares for diluted EPS calculation.
As stated in HKAS 33 paragraph 46, options and warrants are dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares during the period. In one case, an entity granted share options to employees under a new share option scheme implemented during the year but the granted share option was not taken into account in the diluted EPS calculation.

In another case, the calculation of diluted EPS inappropriately included anti-dilutive potential ordinary shares. The potential effect on the numerator and the number of the relevant potential ordinary shares from the denominator in the diluted EPS calculation resulted in a higher diluted EPS.

3. Classification of investments

Some entities held a majority equity interest of an investment which was not accounted for as a subsidiary. Conversely, some companies held less than 50% interest of the investment but that investment was classified as subsidiary.

Classification of an investment as subsidiary, jointly-controlled entity or associate depends on the extent of control or significant influence exercised or exercisable by the investor which should be based on the terms of shareholder agreement. Given that it is normal to expect that the percentage of voting power is in proportion with the percentage of ownership, entities are required to disclose the basis for determining the classification of investment if the abovementioned situations occur.
Communications with members

The results of both programmes are used to assist members to improve their understanding and application of professional standards and raise the quality of auditing and financial reporting. Common issues found under the review programmes were communicated to members through different channels:

- The QAD hosted two forums in July and August 2010 that attracted a combined audience of over 370. The forums guided attendees through the quality assurance annual report and discussed common issues identified from practice review and professional standards monitoring.

- In October 2011, the QAD organized a joint forum with the FRC and HKEx which drew approximately 280 attendees. Common issues identified from the review programmes of financial statements of Hong Kong listed companies carried out by the three bodies were presented.

- Key findings identified from reviews of Practices with listed clients under the practice review programme were covered in a Financial and Auditing Alert in 2011.

Findings from the reviews have also been used by the Institute’s technical team in providing relevant support for members through ongoing training sessions.
### Members of the Standards & Quality Accountability Board in 2011

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Company</th>
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<tbody>
<tr>
<td>Mr. BEST, Roger Thomas</td>
<td>Chairman</td>
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<tr>
<td>Mr. CHONG, Kim</td>
<td>Member</td>
<td>Hong Kong Monetary Authority</td>
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<tr>
<td>Mr. GRIEVE, Charles Ramsay</td>
<td>Member</td>
<td>Securities &amp; Futures Commission</td>
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<tr>
<td>Mr. KENNEDY, Paul</td>
<td>Member</td>
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<tr>
<td>Mr. LAM, Wai Man, Frankie</td>
<td>Member</td>
<td>The Treasury, HKSAR</td>
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<td>(Appointed 1 June 2011)</td>
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<tr>
<td>Mr. MAR, Selwyn</td>
<td>Member</td>
<td>Nexia Charles Mar Fan &amp; Co.</td>
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<td>(Stepped down 31 August 2011)</td>
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<tr>
<td>Mr. WINKELMANN, Paul Franz</td>
<td>Member</td>
<td>PricewaterhouseCoopers</td>
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<tr>
<td>Mrs. WONG CHUI, Yue Chue, Lesley</td>
<td>Member</td>
<td>The Treasury, HKSAR</td>
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<td>(Stepped down 1 June 2011)</td>
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<tr>
<td>Mr. WONG, Tat-cheong, Frederick</td>
<td>Member</td>
<td>Audit Commission, HKSAR</td>
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<td>(Appointed 28 October 2011)</td>
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<td>Mr. WONG, Ying-tao, Peter</td>
<td>Member</td>
<td>Audit Commission, HKSAR</td>
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### Members of the Practice Review Committee in 2011

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<thead>
<tr>
<th>Name</th>
<th>Position</th>
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<tr>
<td>Ms. CHAN, Mei Bo, Mabel</td>
<td>Chairman</td>
<td>Mabel Chan &amp; Co.</td>
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<tr>
<td>Mr. CROWE, William Andrew</td>
<td>Deputy Chairman</td>
<td>KPMG</td>
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<tr>
<td>Mr. GEORGE, Richard John Weir</td>
<td>Deputy Chairman</td>
<td>Deloitte Touche Tohmatsu</td>
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<tr>
<td>Mr. CHENG, Kin Chung</td>
<td>Member</td>
<td>Poly Genius Consulting Limited</td>
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<tr>
<td>Ms. CHEUNG, Yuk Ting, Mabel</td>
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<td>PricewaterhouseCoopers</td>
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<tr>
<td>Ms. FUNG, Yee, Pammy</td>
<td>Member</td>
<td>Crowe Horwath (HK) CPA Limited</td>
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<td>Mr. HON, Koon Fai, Alex</td>
<td>Member</td>
<td>HLB Hodgson Impey Cheng</td>
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<td>Ms. KWOK, Yuen Man, Eunice</td>
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<td>Mazars CPA Limited</td>
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<td>Mr. LEUNG, Kwok Ki, Alden</td>
<td>Member</td>
<td>Ernst &amp; Young</td>
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<td>Mr. POON, Tsun Wah, Gary</td>
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<td>Mr. TAM, King Ching, Kenny</td>
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<td>Kenny Tam &amp; Co.</td>
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<td>Ms. TANG, Kwan Lai</td>
<td>Member</td>
<td>SHINEWING (HK) CPA Limited</td>
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<tr>
<td>Ms. YAM, Hoi Yin, Cecilia</td>
<td>Member</td>
<td>BDO Limited</td>
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<td>Mr. YUEN, Siu Bun, Edward</td>
<td>Member</td>
<td>Hsin Chong Construction Group Limited</td>
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## Members of the Professional Standards Monitoring Expert Panel in 2011

<table>
<thead>
<tr>
<th>Name</th>
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<tr>
<td>Mr. CHAN, Tak Shing</td>
<td>BDO Limited</td>
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<tr>
<td>(Stepped down 15 July 2011)</td>
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<tr>
<td>Mr. CHENG, Chung Ching, Raymond</td>
<td>HLB Hodgson Impey Cheng</td>
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<tr>
<td>Ms. CHEUNG, Sau Ying, Olivia</td>
<td>Hong Kong Exchanges and Clearing Limited</td>
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<tr>
<td>Mr. CHOW, Siu Lui, Jack</td>
<td>KPMG</td>
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<tr>
<td>Mr. DEALY, Nigel Derrick</td>
<td>PricewaterhouseCoopers</td>
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<tr>
<td>Mr. HO, Che Kong, John</td>
<td>Leighton Asia Limited</td>
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<tr>
<td>Ms. HO Man Ching, Elsa</td>
<td>Mazars CPA Limited</td>
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<tr>
<td>Ms. HSIANG, Yuet Ming, Fanny</td>
<td>BDO Limited</td>
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<tr>
<td>(Stepped down 9 February 2011)</td>
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<tr>
<td>(Re-joined 8 August 2011)</td>
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<tr>
<td>Mr. POGSON, Timothy Keith</td>
<td>Ernst &amp; Young</td>
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<tr>
<td>Mr. TAYLOR, Stephen</td>
<td>Deloitte Touche Tohmatsu</td>
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<tr>
<td>Mr. YAN, Yiu Kwong, Eddy</td>
<td>Crowe Horwath (HK) CPA Limited</td>
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