



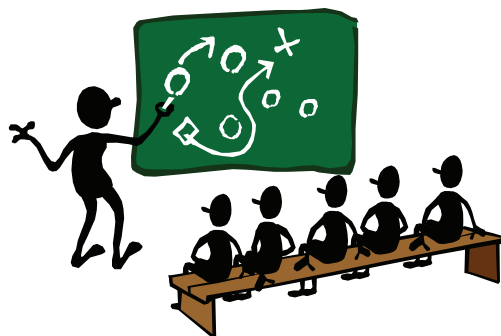
## **A Refresher Course on Current Auditing Standards**

### **Day 1**

<b>Time</b>	<b>Topic</b>
8:30 - 9:00	Registration
9:00 - 9:50	Preliminary engagement activities and overall audit strategy
9:50 - 10:30	Understanding the entity and its environment
10:30 - 10:45	Break
10:45 - 11:45	Understanding and evaluating internal control
11:45 - 12:15	Financial statement assertions
12:15 - 13:00	Materiality
13:00 - 14:00	Lunch
14:00 - 15:00	Risk identification, assessment and evaluation
15:00 - 15:45	Risk assessment procedures
15:45 - 16:00	Break
16:00 - 17:00	Risk of fraud

Presented by : Winnie Chan, Associate Director, Technical Learning and Support, HKICPA  
Eky Liu, Manager, Technical Learning and Support, HKICPA  
Venue: The Hong Kong Institute of Certified Public Accountants

# ***A Refresher Course on Current Auditing Standards 2013 (Day 1)***



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## **Agenda of today**

- 1. Preliminary engagement activities and overall audit strategy**
- 2. Understanding the entity and its environment**
- 3. Understanding and evaluating internal controls**
- 4. Financial statement assertions**
- 5. Materiality**
- 6. Risk identification, assessment and evaluation**
- 7. Risk assessment procedures**
- 8. Risk of fraud**



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# PART 1

## Preliminary engagement activities and overall audit strategy



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## Preliminary engagement activities

### What are Preliminary Engagement Activities ?

- HKSA 300.6 states that the auditor shall undertake the following activities at the beginning of the current audit engagement:
  - (a) Performing procedures required by HKSA 220 regarding the continuance of the client relationship and the specific audit engagement;
  - (b) Evaluating compliance with relevant ethical requirements, including independence, in accordance with HKSA 220; and
  - (c) Establishing an understanding of the terms of the engagement, as required by HKSA 210.3



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## Preliminary engagement activities

- It is essential that a firm providing audit and other professional services carefully considers its decisions to accept clients and to retain them. For an audit, this important step must take place at the start of the entire audit process.

### Why must this be done?

- If the auditors don't decide carefully, poor decisions could lead to repercussions such as:
  - inability to perform a quality audit to appropriate standards;
  - potential law suits;
  - loss of reputation;
  - stress on staff and partners;
  - unbillable time;
  - unpaid fees.



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## Preliminary engagement activities

### Which **standards** should we look for in relation to preliminary engagement activities?

- HKSA 210 Agreeing the terms of audit engagements
- HKSA 220 Quality control for an audit of financial statements
- HKSA 300 Planning an audit of financial statements
- HKSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements



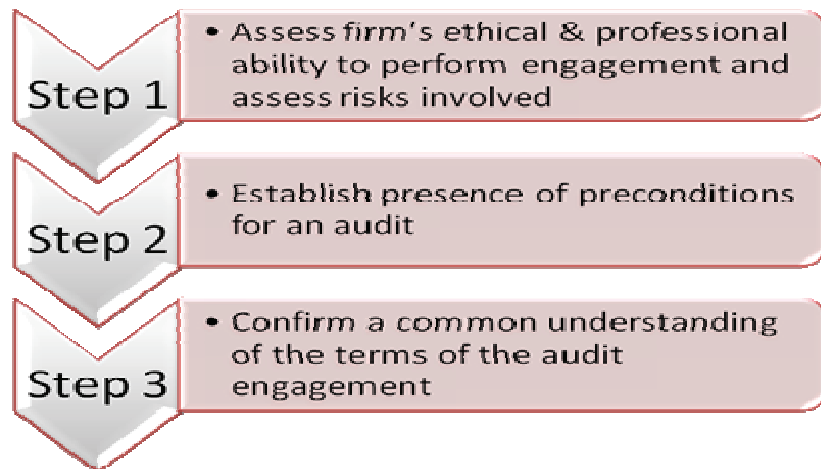
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## Preliminary engagement activities

- Hence the three key steps are as shown in the diagram.

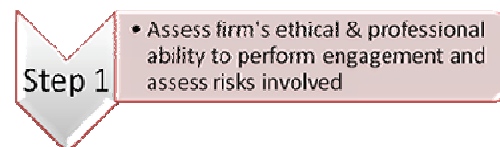


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## Engagement acceptance and continuance



- Firstly the auditor must assess the ability to perform the engagement and the risks involved. This involves obtaining information to answer questions as follows.
  - Does the firm have the competence, resources and time required?
  - Can the firm comply with ethical and independence requirements?
  - Are the risks involved bearable?
  - Does the client lack integrity?



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## Engagement acceptance and continuance

### A. (Firm-level) - Does the firm have the **competence, resources and time required**?

#### Considerations

1. Is the firm professionally qualified to act?
2. Does the firm have the right staff with the right skills e.g., do they have knowledge of the industry, or experience of the regulatory requirements?
3. What is the nature and scope of the audit?
4. Does the firm have adequate existing resources?
5. What are the deadlines for completion of the audit and are the deadlines achievable given the resources available?
6. Are experts available if required?
7. Are there qualified persons to perform an engagement quality review if applicable?

## Engagement acceptance and continuance

### B. (Firm-level) - Does the firm comply with **ethical and independence requirements**?

#### Considerations

1. What ethical and independence requirements that firm has to comply with?
2. Are there any conflicts of interest?
3. Are there any identified independence threats? Has appropriate action been taken to reduce those threats and bring them to an acceptable level?
4. If this is not possible, have steps been taken to withdraw from the engagement?

# Engagement acceptance and continuance

## C. (Client) - Are the **risks** involved bearable?

### Considerations

1. For new engagements, have the previous auditors informed the auditor of any reasons for declining the engagement?
2. What are the entity's values/culture and how competent are TCWG and senior management?
3. Are there complex issues to address e.g., accounting estimates, difficult accounting policies?
4. Have there been significant changes in the period that could impact the engagement e.g., key staff changes, departure of a Finance Director, a new accounting system?
5. What is the nature of operation?
6. Is there a high level of public interest in the entity?
7. Is the entity in good financial health?
8. Any pressure from the client to keep the billable hours at an unreasonably low level?

# Engagement acceptance and continuance

## D. Does the client lack **integrity**?

### Considerations

1. Are there any unrealistic limitations e.g., short reporting deadlines, lack of access to documentation?
2. Are there any indications that the entity may be involved in money laundering or other criminal activities?
3. Does the company carry out unusual transactions?
4. Does the client select aggressive accounting policies ? How's the internal control environment?
5. What is the identity and business reputation of related parties?
6. Is there any event that casts doubt over the owners, senior management and those charged with governance of the entity e.g., business practices, history of ethical or regulatory infringements, lawsuits, negative publicity?

# Engagement acceptance and continuance

## Where can we find the above information?

- Sources of information **could** include:
  - communications with existing or previous auditors;
  - inquiry of third parties such as bankers, legal counsel and industry peers; and
  - background searches.
  - prior engagement and planning for the continuing engagement
- The table shows examples of the useful information and how it could be obtained.

Information	Information sources
Integrity	<ul style="list-style-type: none"><li>• Accounting policies</li><li>• Qualifications of Finance Director</li><li>• References for key personnel from solicitors and bankers</li><li>• Communication with previous auditors</li></ul>
Financial position, resources and outlook	<ul style="list-style-type: none"><li>• Previous year annual accounts and financial reports</li><li>• Enquiries from banks</li><li>• Forecasts</li><li>• Credit rating</li><li>• Regulatory filings</li><li>• Industry press</li></ul>
Internal controls	<ul style="list-style-type: none"><li>• Published financial statements</li><li>• Internal audit reports (with permission)</li></ul>
Industry	<ul style="list-style-type: none"><li>• Rules and standards that relate to that industry</li></ul>



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# Engagement acceptance and continuance

## How do we show that we have performed client acceptance and continuance?

- Firm can develop / use standard industry – accepted checklist / questionnaire / templates to ensure consistent application of the acceptance and continuance considerations
- These templates must be completed and reviewed before the start of all engagements
- The firm shall document the decision and how issues identified were resolved. The engagement partner or senior personnel should approve and sign off the decision to accept or continue an engagement.
- In the instance of smaller firm, where a single partner may be responsible for both client acceptance and ethics, a policy might be adopted that requests second partner approval for clients with higher risks



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## Engagement acceptance and continuance



### 2012 Quality Assurance report

- documentation on files did not demonstrate a rigorous assessment of client and fraud risk had been performed
- extra caution should be exercised when accepting a client with modified audit opinion, a regular change of auditor and negative media portrayal
- firm has sufficient expertise and resources to handle listed client?



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## Engagement acceptance and continuance

### Will you accept this client? Why?

- significant control weaknesses
- questionable management integrity
- lack of Finance Director
- doubtful accounting policies
- previous auditor resignation



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## Engagement acceptance and continuance

**If, after accepting or continuing an engagement, the firm receives information, which, if known earlier, would have resulted in a refusal of the engagement,**

- the firm should consider whether to continue the engagement and will normally seek legal advice regarding its position and options to ensure that it meets any professional, regulatory, and legal requirements

**Before submitting a new client proposals,**

- the firm should have performed an evaluation of a prospective client and authorised approval should be made.
- The review process must be undertaken and documented before the firm can accept the engagement and release the letter of engagement.

**In case of resignation of a client relationship, the firm should define the process to be followed, e.g.**

- Consideration of the professional, regulatory, and legal requirements
- Meeting with client's management and TCWG to discuss the facts
- Document the significant matters leading to the withdrawal

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## Establish preconditions for an audit

Step 2

- Establish presence of preconditions for an audit

- HKSA 210.3 states that the objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:
  - a) Establishing whether the preconditions for an audit are present; and
  - b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.
- **What are preconditions for an audit?**
  - the use by management of an acceptable financial reporting framework when preparing the financial statements; and
  - Obtaining the agreement of management that it acknowledges and understands its responsibilities in relation to the conduct of the audit.

## Establish preconditions for an audit

- What are the responsibilities of management that it should acknowledge and understands?
  - (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
  - (ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
  - (iii) To provide the auditor with:
    - a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
    - b. Additional information that the auditor may request from management for the purpose of the audit; and
    - c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.



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## Establish preconditions for an audit

What happens if management won't comply?

- If management doesn't acknowledge its responsibilities or imposes a limitation on the scope, the auditor will not be able to obtain sufficient appropriate audit evidence during the course of the audit.
- If this happens, the auditor will have to decline the engagement unless local laws or regulations say otherwise
- Equally the auditor would also have to decline if the financial reporting framework adopted was not appropriate



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## Agree terms

### Step 3

- Confirm a common understanding of the terms of the audit engagement

- To ensure a clear understanding between management and the auditor on the terms of the engagement, **HKSA 210** requires that an engagement letter (or other suitable written agreement) must be prepared and agreed with management or Those Charged With Governance (if different) after appointment

### When?

- There is no prescribed date, but it is in the interests of both the entity and the auditor to make sure that this is sent out by the auditor **before** the commencement of the audit to make sure there are no misunderstandings during the audit



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## Agree terms

What should an engagement letter include?

- the objective and scope of the audit of financial statements;
- auditor responsibilities;
- management responsibilities;
- applicable financial reporting framework;
- reference to the expected form and content of audit reports to be used (including a statement that there may be circumstance when the report may differ from expectation).
- Other common points may include:
  - planning and performance arrangements;
  - basis of audit fees and billing arrangements;
  - the fact that inherent limitations of audit exist such that there are always unavoidable risks that some material misstatements may remain undetected;
  - the form of any other communications resulting from the engagement;

Refer to Annex 1 or the Appendix of HKSA 210



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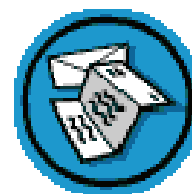
## Agree terms

### Common questions on audit engagement letter

1. Where can we find the updated example of an audit engagement letter?
2. Is a new letter needed every year?
3. How many letters are needed in a group situation?
4. If the financial statements are prepared in accordance with SME-FRF & FRS, HKFRS for PE, can we still use the same sample audit engagement letter?



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## Agree terms

### Common issues on engagement letter

- a) It was dated before client acceptance/continuance date
- b) No engagement letter was signed for issuance of compliance report for insurance broker and regulated entities
- c) No verification on title/position for the person who signed the engagement letter on behalf of the company
- d) Unclear scope of work for issuing audited financial statements of individual subsidiaries in a signed engagement letter
- e) Subsidiaries attached in legal letter is not the same in the engagement letter



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## Agree terms

### What do the auditors do if management requests a change to the terms?

- The auditor should not agree to a change **unless there is a reasonable justification**
- It would not be reasonable if motivated by issues raised during the audit. E.g. if the auditor is unable to obtain sufficient appropriate evidence on inventory balances, and the entity asks the audit engagement to be changed from an audit to a review engagement (for which less evidence has to be gathered) to avoid negative implications for the audit opinion

### Reasonable request for change?

Reasonable	Unreasonable
Change in clients circumstances	Inability to obtain certain audit information
Misunderstanding of original service requested	Unsatisfactory evidence



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## Agree terms

### What do the auditors do if management requests a change to the terms? (cont'd)

- If the change is reasonable, however, **a revised engagement letter would be agreed**
- If the auditor cannot agree to a change in the terms and management is not content to continue with the previously agreed terms, then the auditor should withdraw from the engagement and determine if this needs to be reported to anyone such as TCWG or regulators



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## Overall audit strategy

- **HKSA 300** sets out the planning activities for an audit to be carried in an effective manner.
- Two levels of planning :



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## Overall audit strategy

The overall audit strategy is a document which will include considerations of :

<b>Engagement characteristics that define the scope of the audit</b>	<ul style="list-style-type: none"> <li>- Economic factors and industry conditions</li> <li>- Number and locations of components to be included</li> <li>- The reporting currency</li> <li>- Control relationships in group of companies</li> </ul>
<b>Ascertain the reporting objectives</b>	<ul style="list-style-type: none"> <li>- Reporting framework</li> <li>- Plan the timing of the audit</li> <li>- The nature of the communication required</li> </ul>
<b>Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts</b>	<ul style="list-style-type: none"> <li>- When is work to be carried out</li> <li>- Timetable for reporting</li> <li>- What will materiality be</li> <li>- What are the specific audit risks</li> <li>- Will internal controls be tested</li> </ul>



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## Overall audit strategy

The overall audit strategy is a document which will include considerations of (cont'd) :

### Consider the results of preliminary activities

- Where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant

### Ascertain the nature, timing and extent of resources necessary to perform the engagement

- Which team members are available,
- What are their skills
- How will they be used on the audit

**Refer to Appendix of HKSA 300 for the detailed list of considerations in establishing the overall audit strategy**



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## Overall audit strategy

### Information sources for setting audit strategy

- previous experience of entity;
- acceptance and continuation procedures;
- discussions with clients on changes since last period and current operating results;
- audit team discussions and meeting;
- external sources;
- knowledge of available resource levels.

### How long does the audit strategy take to complete?

Depending on the following:

- size and complexity of entity;
- previous experience of the entity;
- circumstances encountered when performing the audit (which could mean that changes are required to the audit strategy);
- composition and size of team (smaller audits will need a smaller audit team making planning easier).



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## Overall audit strategy

### When do we need to prepare the overall audit strategy and audit plan?

- Development of the overall audit strategy will begin at the start of the engagement and is completed and updated during the audit.
- The detailed audit plan will be developed when risks of material misstatement have been identified and assessed. The overall strategy including timing, staffing and supervision can be finalised by then.

The audit strategy and detailed audit plan are closely interrelated. Changes in one may result in consequential changes to the other.



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## Overall audit strategy

### Communicating the plan

- Under HKSA 260, the auditor is required to communicate with Those charged with governance ("TCWG") an overview of planned scope and timing of the audit. This may help management and TCWG to:
  - understand the consequences of the auditor's work;
  - discuss issues of risk and materiality with the auditor; and
  - identify areas in which they would like the auditor to undertake some more work.
- It may also help the auditor to understand the entity better.
- Risk and materiality will be explained in more detail in later sessions.



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## Overall audit strategy

### What should be documented, Why and How?

- The following table outlines the key documentation requirements of HKSA 300, in relation to the audit strategy and plan:

What?	Why?	How (examples)?
<b>Overall audit strategy</b>	<ul style="list-style-type: none"><li>To record key decisions to plan audit and to communicate to engagement team</li></ul>	<ul style="list-style-type: none"><li>Memorandum containing key decisions regarding scope, timing and conduct of audit</li><li>Refer to <a href="#">Annex 2</a> for an example</li></ul>
<b>Audit Plan</b>	<ul style="list-style-type: none"><li>To record the planned nature timing and extent of risks assessment procedures and further audit procedures</li><li>To ensure a record of the plan is available for review and approval, prior to performance</li></ul>	<ul style="list-style-type: none"><li>Standard audit programs (tailored to circumstances)</li><li>Audit completion checklists</li></ul>
<b>Significant changes to overall audit strategy or plan and reasons for change</b>	<ul style="list-style-type: none"><li>To record reasons for significant changes and the final strategy and plan adopted</li><li>To reflect the response to significant changes</li></ul>	<ul style="list-style-type: none"><li>As appropriate to engagement</li></ul>



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## Overall audit strategy

### Additional considerations in initial audit engagements (cont'd)

When writing the audit strategy and plan the auditor will need to:

- if appropriate, make arrangements with the previous auditor to review their prior year working papers;
- consider the impact of any major issues discussed as part of the acceptance procedures;
- consider audit procedures necessary to obtain sufficient appropriate evidence on opening balances; and
- consider other procedures required by the firm's own system of quality control over initial engagements.



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# PART 2

## Understanding the entity and its environment



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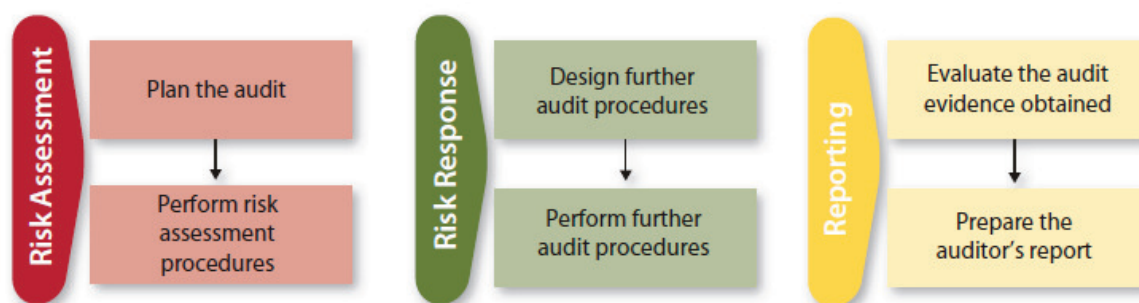
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## The risk-based audit - overview

HKSA 200.11. In conducting an audit of financial statements, the overall objectives of the auditor are:

- (a) To obtain **reasonable assurance** about whether the financial statements as a whole are **free from material misstatement, whether due to fraud or error**, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework;



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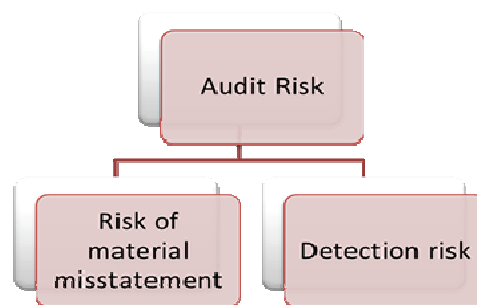
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## Audit risk elements

- Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.
- Audit risk has two key elements:



Risk of material misstatement (RoMM)

Risk that the financial statements are materially misstated prior to the start of any audit work

Detection risk (DR)

Risk that audit procedures performed don't detect a misstatement(s) that could be material individually or in total.

- This means that for the auditor to be able to reduce audit risk to an acceptable level, the auditor needs to:
  - identify and assess the risks of material misstatement; and
  - limit detection risk.



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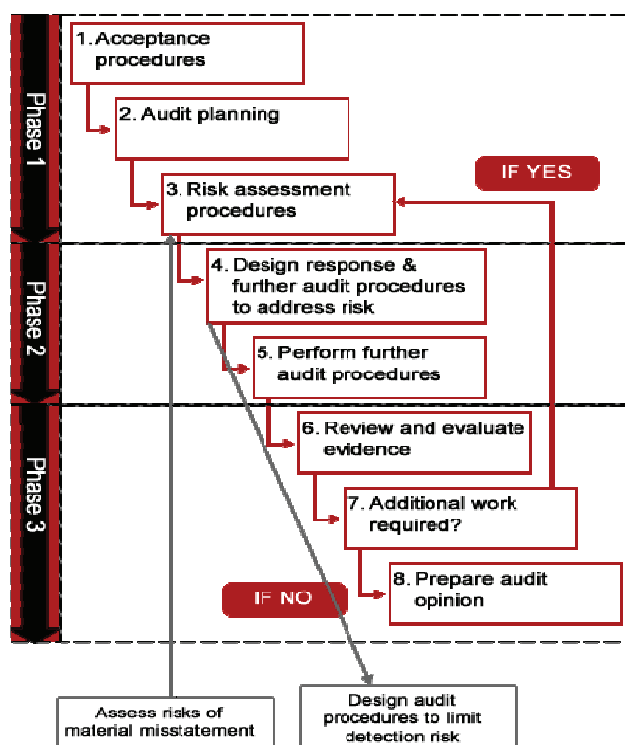
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## Audit risk elements

### Where does this fit in the audit process?

HKSA 315 *Identifying and assessing the risks of material misstatement* deals with the auditor's responsibility to identify and assess the risks of material misstatement.



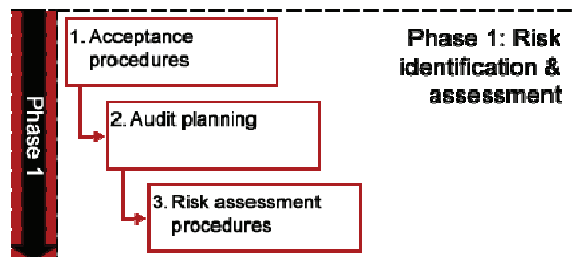
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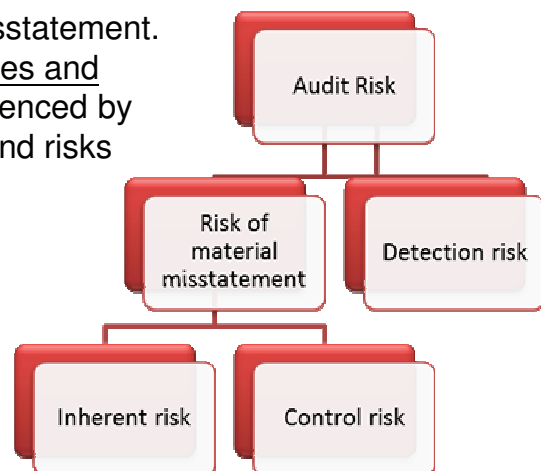
## Audit risk elements

- HKSA 315 requires that an auditor:
  - should identify and assess the risks of material misstatement (RoMM) whether due to fraud or error at the financial statement and assertion level; and
  - has a thorough understanding of the entity including its internal control environment.
- Once this is performed, the auditor is in a position to respond to these assessed risks and decide what procedures need to be done to keep audit risk to an acceptable level.
- The auditor must understand more about the component parts of RoMM and what information will help identify and assess the risks.



## Inherent and control risk

- Audit risk has two key elements, RoMM and detection risk. RoMM is the risk that the financial statements may contain a material misstatement. It relates purely to the business activities and controls at the entity. It cannot be influenced by the auditor as it relates to conditions and risks within the entity itself.
- The two components of RoMM are:
  - inherent risk; and
  - control risk



# Inherent and control risk

## Inherent risk

### Definition

- The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement (individually or in total with other misstatements) that could be material before considering the impact of any controls.

### Example

- If a company belongs to an industry where there is continuous innovation causing products to quickly become obsolete, the assertion that inventory is valued appropriately will be inherently more risky. Why?



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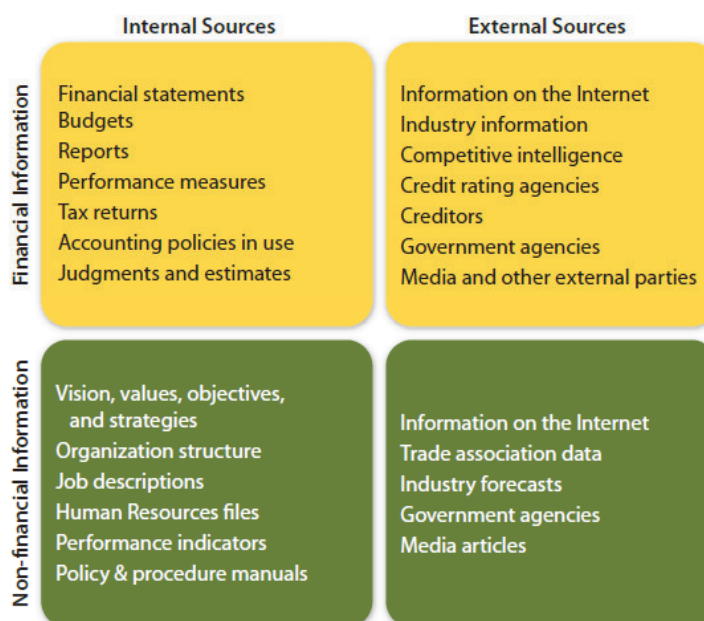
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# Inherent and control risk

## Inherent risk (Cont'd)

- Sources of information
- HKSA 315 requires the auditors to understand the entity and its environment in six key areas. That also provides information on inherent risk.



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# Inherent and control risk

## Control risk

### Definition

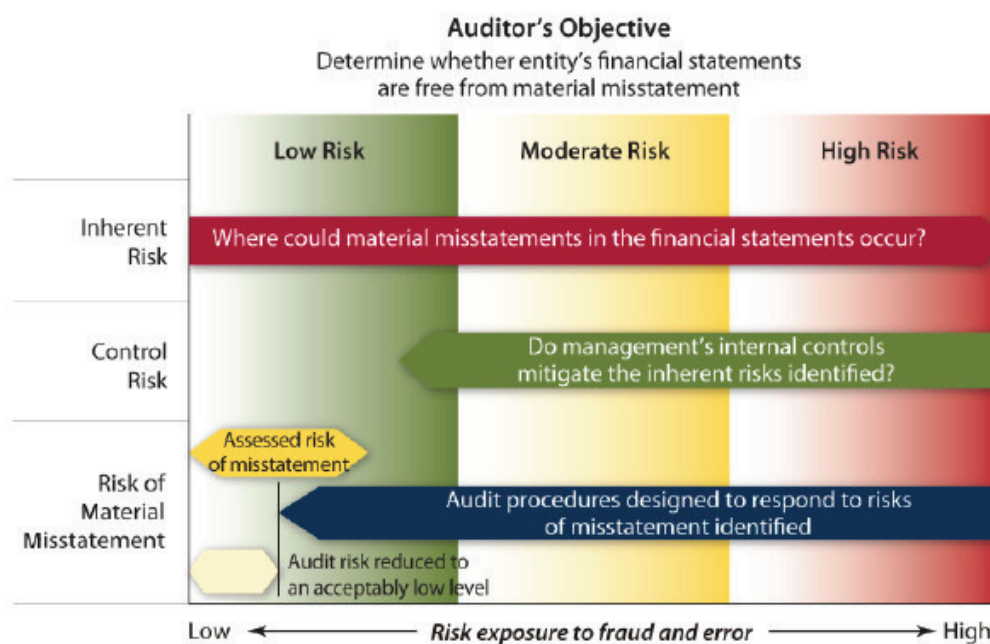
- The risk that a misstatement could occur in an assertion about a class of transaction, account balance or disclosure and that could be material (either individually or in total with other misstatements) will not be prevented or detected and corrected on a timely basis by the entity's internal control.

### Explanation

- Management designs and implements controls to mitigate against business risks to reduce its risk exposure to a tolerable error. These controls may be either pervasive controls or specific controls
- If these controls don't mitigate the risk they were designed to protect against, there is a control risk.
- The auditor can preliminarily assess the control risk of the entity through understanding and evaluating the internal controls of the entity.

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# Inherent and control risk



## Inherent and control risk

Practical examples – which risk?

### New finance

- If an organisation is seeking to raise finance for a new venture.....

### High staff turnover

- If an organisation has a high turnover of staff in the accounts department.....

### Use of sampling

- If the auditor uses techniques that do not involve 100% testing of items.....



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## Inherent and control risk

Practical examples – which risk? (cont'd)

### ▪ New finance

If an organisation is seeking to raise finance for a new venture, this would pose an **inherent risk** as it could expose the financial statements to management bias (to overstate assets to secure finance).

### ▪ High staff turnover

If an organisation has a high turnover of staff in the accounts department, this would pose a **control risk** as there would be less experienced staff available to prepare and review the figures within the financial statements.

### ▪ Use of sampling

If the auditor uses techniques that do not involve 100% testing of items, this will pose **detection risk** as due to this approach there is a risk that the auditor may not detect material misstatement.



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## Inherent and control risk

Armed with the knowledge of the two components of the RoMM, the auditor can focus on the foundation of the audit process – identifying RoMM by:

- understanding the entity and its environment to identify inherent risks;
- understanding the entity's internal controls to identify control risks.

### Exercise 2

Refer to exercise 2 on inherent risk, control risk and detection risk.



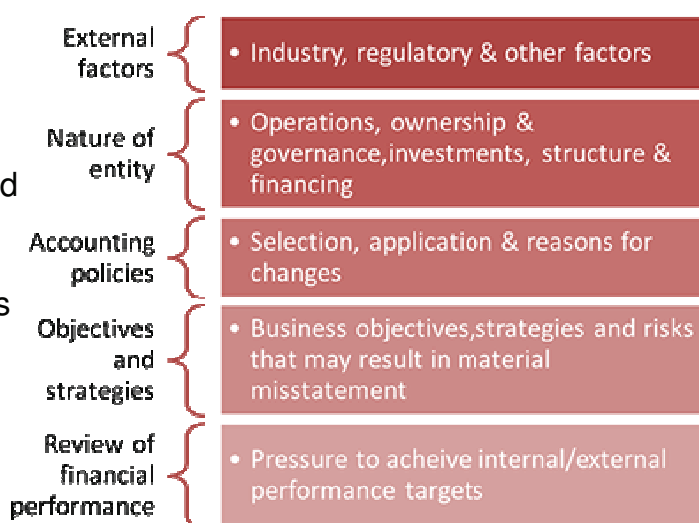
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## Obtain an understanding of the entity and its environment (in relation to inherent risks)

- HKSA 315 requires that based on the information gathered the auditor will use risk assessment procedures (explained later) to obtain and document an understanding of the entity and its environment in five key areas plus internal controls (which will be covered later). The five areas excluding controls are shown in the diagram.



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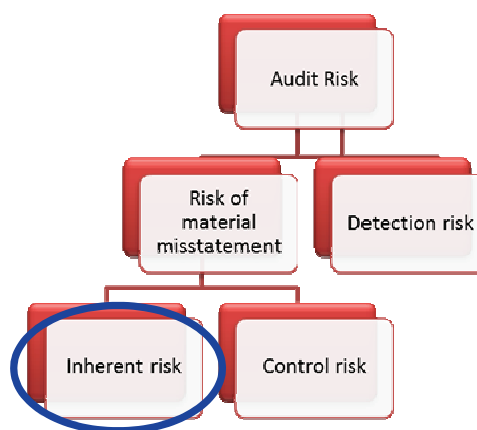
## Obtain an understanding of the entity and its environment (in relation to inherent risks)

### ▪ Sources of risks

Refer to Annex 3 for an example of the sources of risk.

### ▪ Documentation

Refer to Annex 4 for an example of the documentation of understanding the entity and its environment.



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## Obtain an understanding of the entity and its environment (in relation to inherent risks)

- Errors and fraud in the financial statements that arise from inherent risk factors will have their origin in one or more of the above areas of understanding the entity e.g.,

### ▪ External factors

A new and complex accounting standard has been introduced. This could increase the risk of incorrect interpretation of the accounting standard and therefore there is a potential for material misstatement

- When HKAS 32 and HKAS39 were introduced as new financial reporting standards about financial instruments, they were highly criticised as being the most complex accounting standards to have ever been introduced. Many experienced accountants had difficulties interpreting and applying these standards. This would have increased the level of inherent risk in companies holding material amounts of financial instruments, just because of the new regulations



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## Obtain an understanding of the entity and its environment (in relation to inherent risks)

### ▪ Objectives and strategies

- A company has set aggressive objectives and strategies. This could increase the risk of aggressive earnings management techniques and the risk of management intentionally inflating performance in the financial statements in order to deliver to shareholders' expectations.
- In the years leading up to Enron's demise, the CEO and Chairman, outlined a grand vision for Enron. They wanted to transform Enron from top in its field to master of the planet. The company's vision changed from 'To be the world's leading energy company' to 'To be the World's leading company'. This aggressive vision explains the resulting aggressive earnings management techniques that were shown in the financial statements. The CEO described the Enron financial statements as 'a black box – too complex for outsiders'.



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## PART 3

# Understanding and evaluating internal controls



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## Internal controls - Overview

Questions:

1. What are internal controls?
2. When does the auditor need to do with the internal controls of the entity?
3. What procedures does the auditor need to perform related to internal controls?



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## Internal controls - Overview

Questions:

1. What are internal controls?

The process designed, implemented and maintained by those charged with governance, management and other personnel to **provide reasonable assurance about the achievement of an entity's objectives** with regard to reliability of **financial reporting**, effectiveness and efficiency of **operations**, and compliance with applicable **laws and regulations**. The term "controls" refers to any aspects of one or more of the components of internal control.



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## Internal controls - Overview

### Questions:

2. When and what does the auditor need to do with the internal controls of the entity?

- HKSA 315.12 states that

*"The auditor shall obtain **an understanding of internal control relevant to the audit**. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgement whether a control, individually or in combination with others, is relevant to the audit."*

Step 1

- HKSA 315.13 further states that

*"When obtaining an understanding of controls that are relevant to the audit, the auditor shall **evaluate the design of those controls and determine whether they have been implemented**, by performing procedures in addition to inquiry of the entity's personnel."*

Step 2

Step 3



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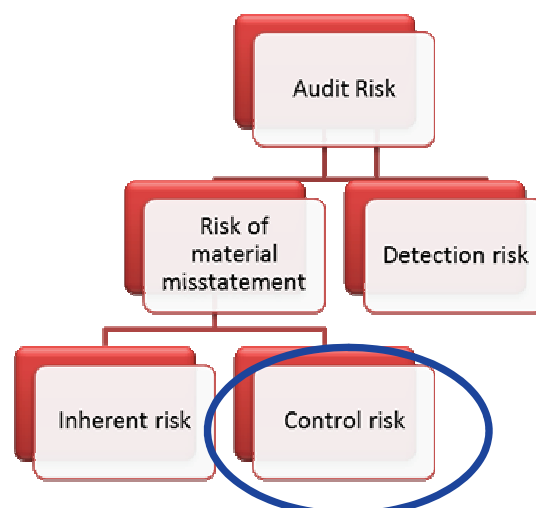
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## Internal controls - Overview

### Questions:

2. When and what does the auditor need to do with the internal controls of the entity? (cont'd)

In addition, understanding and evaluating internal controls helps the auditor identify and assess the control risks.



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### ■ What does the auditor need to understand?

Five components of internal control



The way in which the internal control system is designed and implemented will vary based on the entity's size and complexity. Smaller entities often have less formal means and simpler processes and procedures.



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Control environment

- Foundation for effective internal control, providing discipline and structure for the entity.
- Sets the tone of an organisation, influencing the control consciousness or awareness of its people.

Key elements to address:

1. Communication and enforcement of integrity and other ethical values
2. Commitment to competence
3. Participation by those charged with governance
4. Management's philosophy and operating style
5. Organizational structure
6. Assignment of authority and responsibility
7. Human resources policies and practices

**Good** control environment can sometimes compensate or even replace weak transactional controls. However, **weaknesses** in control environment can undermine and even negate good design in other internal control components.



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### The control environment in smaller entities

- Active involvement of a competent owner-manager may reduce the need for other control activities such as segregation of duties.
- Less documentation (e.g. code of conduct, staff manual) to support control environment controls
- Communicate orally the values and acceptable behaviors
- Auditor's possible work:
  1. Discussions with management
  2. Interview with employees
- Refer to Annex 5 for a list of possible controls in smaller entities.



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Risk assessment

#### How management:

- Identifies risks relevant to financial reporting;
- Estimates the significance of the risks;
- Assesses the likelihood of their occurrence; and
- Decides upon actions to manage them

#### Key elements to address:

1. Changes in operating environment
2. New senior personnel
3. New or revamped information systems
4. Rapid growth
5. New technology
6. New business models, products, or activities
7. Corporate restructurings
8. Expanded foreign operations
9. New accounting pronouncements

#### Smaller entities

- No formal, structured risk assessment processes
- Management assesses risk through direct personal involvement with employees and outside parties
- Discuss with management



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Information system (IS)

Infrastructure, software, people, procedures and data to identify, capture, processes and distribute information supporting financial reporting and internal control objectives.

Key elements to address:

1. Business processes
  - The classes of transactions
  - Procedures of both IT and manual systems for initiating, recording, processing and correcting transactions
  - Accounting records and supportings
  - How IS captures events and conditions?
  - How to prepare financial statements?
  - Controls surrounding journal entries
2. Communications of financial reporting roles and responsibilities



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### The information system in smaller entities

- Less sophisticated and less thoroughly documented information systems
- Some use off-the-shelf accounting software packages with built-in application controls, such as automated reconciliations, reporting of exceptions etc.
- Less formal internal communication due to fewer levels and smaller number of personnel
- Auditor's possible work
  1. Inquiry and observation
  2. Evaluate the application controls



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Control activities

Policies and procedures to ensure that management's directives are carried out. These control activities can be performed within either IT or manual systems.

Typical controls at business process level:

1. Authorization
2. Performance reviews
3. Information processing
4. Physical controls
5. Segregation of duties

### Smaller entities

- Informal and limited documentation
- Limited scope, only related to main transaction cycles, such as revenue
- Segregation of duties are not common due to limited staff
- Risks may be mitigated by the control environment, e.g. heavy involvement by management in day-to-day operation



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Monitoring of controls

- Assess the effectiveness of internal control's performance over time.
- Ensure controls are working properly and if not, take necessary corrective actions
- E.g. Ongoing activities, separate evaluations

### In smaller entities

- Ongoing monitoring are usually informal and built into the normal recurring activities, e.g. regular management and supervisory activities and the review of exception reports.
- Periodic monitoring (such as separate evaluations by internal auditors) is not common in smaller entities.
- Discuss with management the type of monitoring activities, the sources of information used and whether the information is considered reliable.



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Exercise 3

Suppose you are the auditor of an investment entity, ABC Company Limited, that pays its staff payroll by bank auto transfer and in cash. The entity also uses a small stand-alone computer for maintaining its payroll records.

For the payroll function at ABC Company Limited, describe:

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



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Internal controls in a computerised environment

General IT controls	<ul style="list-style-type: none"><li>• policies and procedures that relate to many applications and support the effective functioning of application controls</li><li>• maintain the integrity of information and security of data</li><li>• Includes controls over access security, program change, system software maintenance and acquisition etc.</li><li>• They are usually in the form of IT policies, standards, and guidelines.</li></ul>
IT application controls	<ul style="list-style-type: none"><li>• relate to procedures used to initiate, record, process and report transactions at business process level</li><li>• ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed.</li><li>• E.g. system edit checks of input data, numerical sequence checks, control totals</li></ul>



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

### Internal controls in a computerised environment (cont'd)

IT -  
dependent  
controls

- consists of both manual and IT element.
- E.g. review of monthly financial statements generated by the accounting system and investigate variances

Please refer to Annex 6 for a list of possible general IT controls and application controls.



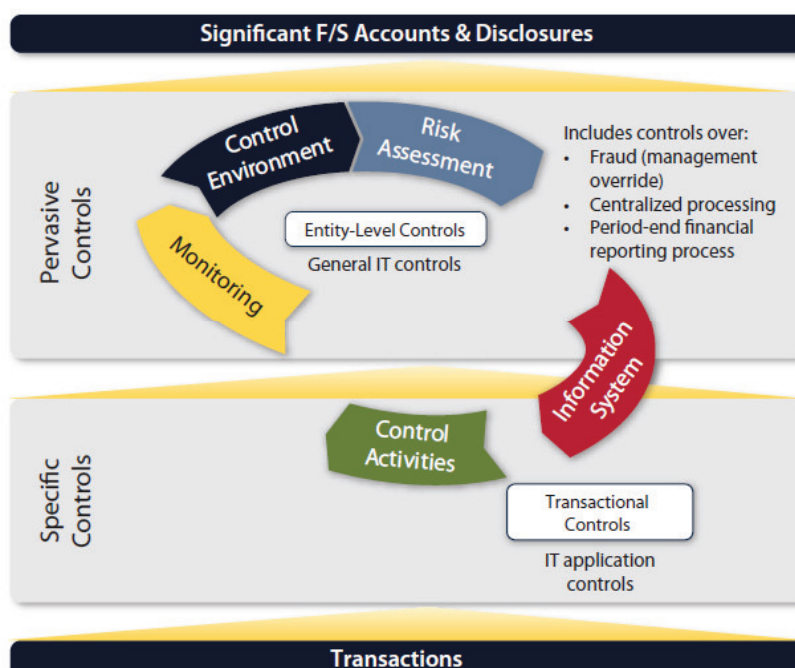
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# Internal controls

## Step 1: Understanding internal control relevant to the audit



### Pervasive/entity-level controls

- usually indirectly prevent a misstatement from occurring, or to detect and correct it after occurrence

### Specific/transactional controls

- relate to particular transaction risks and designed to prevent or detect and correct misstatements directly



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

When understanding internal controls components, consider:

- What are the specific risks of material misstatements requiring mitigation?
- Management's response to the identified risks
- Roles and responsibility when involving both manual and automated controls

### Example

Suppose a warehouse manager is responsible for shipping goods. The warehouse manager manually inputs the data into a sales system that has an application control to match the shipment to the original order. If something goes wrong in the matching process, is it the responsibility of the warehouse manager, the IT department, or the accounting department?



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

When understanding internal controls components, consider (cont'd):

- Is it always true that there is no internal control in the small entities? Consider how the pervasive controls could be evidenced in small entities
- What happens if there are not many control activities that can be identified?
  - Can substantive procedures provide sufficient audit evidence?
  - Concerns about management's integrity, risk of management misrepresentation and fraud
  - Reliability of the entity's controls



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# Internal controls

## Step 1: Understanding internal control relevant to the audit

**What** does the auditor need to document?

- Refer to Annex 7 for an example of documentation of the five internal control components.
- For recording control activities, one or more of the following methods may be used for recording:
  - Narrative notes
  - Flowcharts
  - Questionnaires
  - Checklists
- These records are retained on the permanent file and updated each year.



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# Internal controls

## Step 2. Evaluating the design of internal controls

- **Evaluating** the **design** of a control involves considering whether the control, individually or in combination with other controls, is **capable** of **effectively preventing, or detecting and correcting material misstatements**.
- What does the auditor need to know when evaluating the design of internal control? e.g. bank reconciliation, physical inspection of fixed assets
- Do significant control deficiencies exist?
- What's the problems with this internal control?

Mr. Walker, accountant, periodically checks a sample of fixed assets from the register to the physical assets. However, this is not done on a regular basis and the records are not always retained.



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# Internal controls

## Step 3. Evaluating the implementation of internal controls

Evaluating the implementation of a control involves considering whether the control exist and the entity is using it as intended.

### Assessing the control design and implementation

1. Inquiring of entity personnel.
2. Observing the application of specific controls.
3. Inspecting documents and reports.
4. Tracing transactions through the information system relevant to financial reporting. (i.e. walkthrough)

Inquiry alone, however, is not sufficient for such purposes.

A walkthrough is not a test of the operating effectiveness of a control.



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# Internal controls

## Reminders:

- ✓ Avoid using generic / standard controls
- ✓ Be specific to the client – frequency of controls, name of reports and systems, responsible staff etc
- ✓ Consider the design of control before checking its implementation
- ✓ Document clearly the nature of work undertaken
- ✓ Review of design and implementation of internal controls **DO NOT provide sufficient evidence** that the control operates effectively, and hence DO NOT form part of the audit evidence
- ✓ If there is a change in internal control, consider whether the revised or new controls continue to mitigate the risk factor, or whether there are new risks that have to be mitigated.
- ✓ Communicate appropriately to those charged with governance and management deficiencies in internal control identified under HKSA 265 (Clarified)



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## Internal controls

### Exercise 4

Please refer to Exercise 4 for the background information and answer the following questions:

- (a) Identify any deficiencies in the internal controls of XYZ Limited.  
Discuss the implication of each of the deficiencies identified.
- (b) What internal controls related to the inventory computer system will you consider testing?



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## PART 4

# Financial Statement Assertions



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## Financial statements assertions

- When management makes the representation that *"the financial statements as a whole are presented fairly in accordance with the applicable financial reporting framework"* it actually contains a number of embedded assertions.
- These embedded assertions relate to the recognition, measurement, presentation, and disclosure of various amounts in the financial statements. For example: All sales transactions are recorded in the proper period.



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## Financial statements assertions

- HKSA315.A111 describes the categories of assertions and is summarized below.

Assertions	Classes of transactions	Account balances	Presentation and disclosure
Existence/ occurrence	✓ (occurrence)	✓ (existence)	✓ (occurrence)
Completeness	✓	✓	✓
Rights and obligations		✓	✓
Accuracy	✓		✓
Cutoff	✓		
Classification and understandability	✓		✓
Valuation/allocation		✓	✓



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## Financial statements assertions

### ▪ Exercise

1. Have all the sales transactions been recorded during the year?
2. Have all cash balances that are denominated in foreign currency been translated to the reporting currency at the correct rate?
3. Does the entity have the responsibility to pay the loan balances?



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## Financial statements assertions

### ▪ Exercise

4. Have all the purchases been recorded in the proper period?
5. Have the entity disposed of its motor vehicle during the year?
6. Have the inventory been adjusted for slow-moving and obsolete items?



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## Financial statements assertions

### ▪ Exercise

7. Have all necessary disclosures related to borrowings been made properly?
8. Do the properties recorded by the entity actually exist?



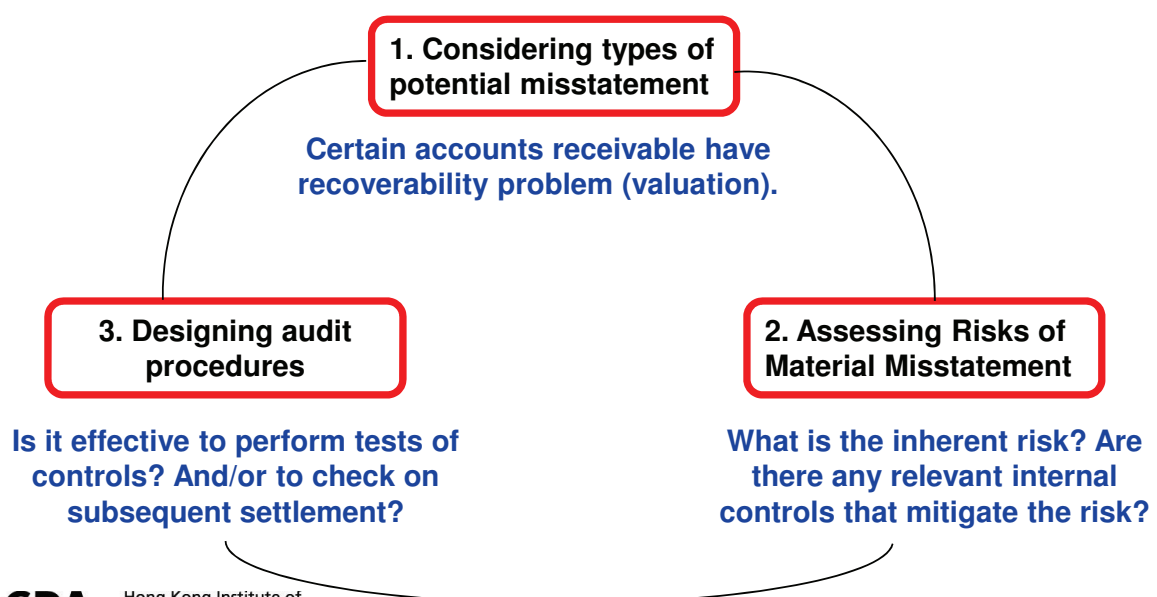
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## Financial statements assertions

### Using assertions in Auditing



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## Financial statements assertions

- The relevance of each assertion to an individual account balance (or transactions or disclosures) will vary based on the characteristics of the balance and the potential risks of material misstatement.
- For example, for valuation assertion, the risk of material misstatement in accounts payable is low; however, for inventory where obsolescence is a factor, the risk is high.



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## PART 5

# Materiality



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## Materiality

Is \$100,000  
undisclosed  
guarantee material?

How about an  
unrecorded liability  
of \$100?

Is 1% of total sales  
material?

*HKSA 200.11 (a): To obtain  
reasonable assurance about whether  
the financial statements as a whole are  
**free from material misstatement**,  
whether due to fraud or error.....;*



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## Materiality

Which auditing standards relate to the consideration of  
materiality?

- HKSA 320 (Clarified) Materiality in Planning and Performing an Audit
- HKSA 450 (Clarified) Evaluation of Misstatements Identified during the Audit



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# Materiality

## Nature of misstatements

- Misstatements may arise from a number of causes. Typical misstatements include:
  - Errors and fraud in preparation of financial statements
  - Departures from the applicable financial reporting framework
  - Fraud perpetrated by employees or management
  - Management error
  - Preparation of inaccurate or inappropriate estimates
  - Inappropriate or incomplete descriptions of accounting policies or note disclosure
- Materiality is not an absolute number. Therefore, the assessment of materiality is always of matter of professional judgment.
- Sometimes, a matter well below the quantitative materiality level may be determined as material based on the nature of the item or the circumstances.

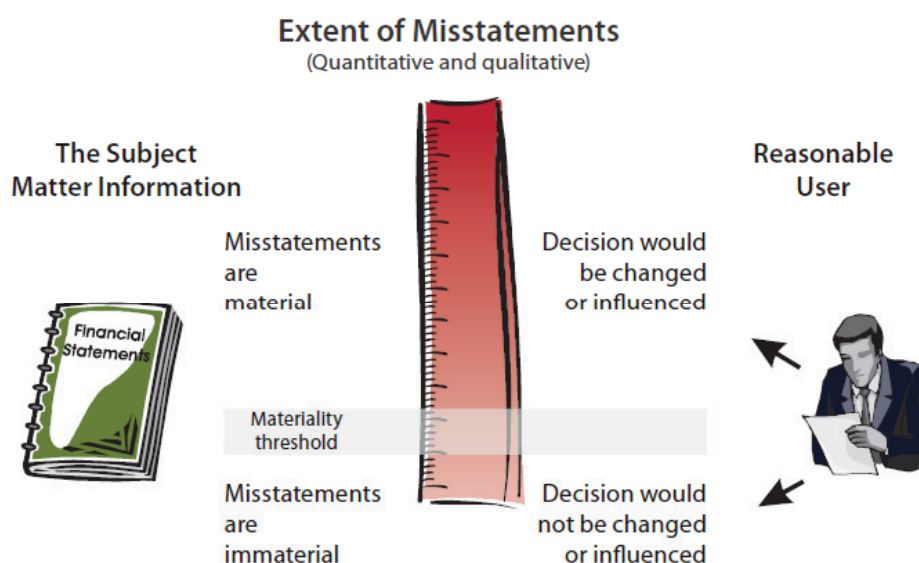


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# Materiality



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# Materiality

## Different levels of materiality

Materiality	Explanation
1. Materiality for the financial statements as a whole ("overall materiality")	- The threshold, above which the financial statements would be materially misstated, i.e. the misstatement is significant enough to influence the economic decision of a user.
	- It differs from engagement to engagement but is normally assessed in terms of a % of a benchmark e.g. profit, revenue, expenses or net assets.

**Materiality for the financial statements as a whole: HK\$500,000**

**Any individual or aggregate misstatements > HK\$500,000  
→ the financial statements is materially misstated.**



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# Materiality

## How to determine overall materiality

- When **determining the benchmark**, the following points should be considered:
  - Primary focus of users / Specific user expectations
  - Relevant financial statements elements
  - Nature of entity
  - Volatility of benchmark
- In general, some **commonly used benchmarks** are as follows:
  - Profit making entities – profit before tax / revenue
  - Investment holding / asset-based entities – total assets or equity
  - Unstable profit / revenue – average of profit / revenue
- Consider to adjust **non-recurring / exceptional items** in the financial statements, e.g. gain/loss on disposal of discontinued operations, discretionary management bonuses, fair value gain/losses on investment properties etc. These items will be dealt with in the specific materiality, which is discussed later.



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## Materiality

### How to determine overall materiality

- Some generally accepted percentage ranges in relation to the most common benchmarks are as follows:

Benchmarks	Typical % ranges
Profit	5 – 10%
Revenue	0.5 – 1.0%
Total assets	0.5 – 1.0%
Equity / Net assets	1.0 – 2.0%

- The major factor in determining the percentage used will be the overall risk of the entity and it is a matter of **professional judgment**.



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## Materiality

### Different levels of materiality

Materiality	Explanation
2. Performance materiality	- It reflects the risk assessments for the financial statement areas.  -It is of lower amount than the materiality for the financial statement as a whole. -It provides a safety buffer for determining the nature and extent of audit procedures to be performed.

**Materiality for the financial statements as a whole: HK\$500,000**  
**Performance materiality: HK\$300,000**



**The buffer of HK\$200,000 provides a safety margin for any undetected misstatements.**



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## Materiality

### How to determine performance materiality

- No specific guidance is provided in the standards
- A common approach is to apply a certain percentage discount on the overall materiality.
- The determination of performance materiality involves the exercise of professional judgment based on factors that address audit risk, such as the following:
  - Understanding of the entity and the results of performing risk assessment procedures;
  - Nature and extent of misstatements identified in previous audits; and
  - Expectations of possible misstatements in the current period.



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## Materiality

### Different levels of materiality

Materiality	Explanation
3. Specific materiality / specific performance materiality	- They are established for specific classes of transactions, account balances or disclosures.
	- Applications are the same as that of the "materiality for the financial statement as a whole" and "performance materiality"



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# Materiality

## Possible examples for specific materiality

Decision influencers	Possible examples
Laws, regulations, accounting framework requirements	<ul style="list-style-type: none"> <li>• Remuneration of management</li> <li>• Related-party transactions</li> <li>• Non-compliance with loan covenants, contractual agreement, regulatory provisions,</li> </ul>
Key industry disclosures	<ul style="list-style-type: none"> <li>• Research and development costs for a pharmaceutical entity</li> <li>• Reserves and exploration costs for a mining entity</li> </ul>
Disclosure of significant events and important changes in operations	<ul style="list-style-type: none"> <li>• Newly acquired businesses or expansion of operations</li> <li>• Discontinued operations</li> <li>• Unusual events or contingencies (e.g. lawsuits)</li> <li>• Introduction of new products and services</li> </ul>



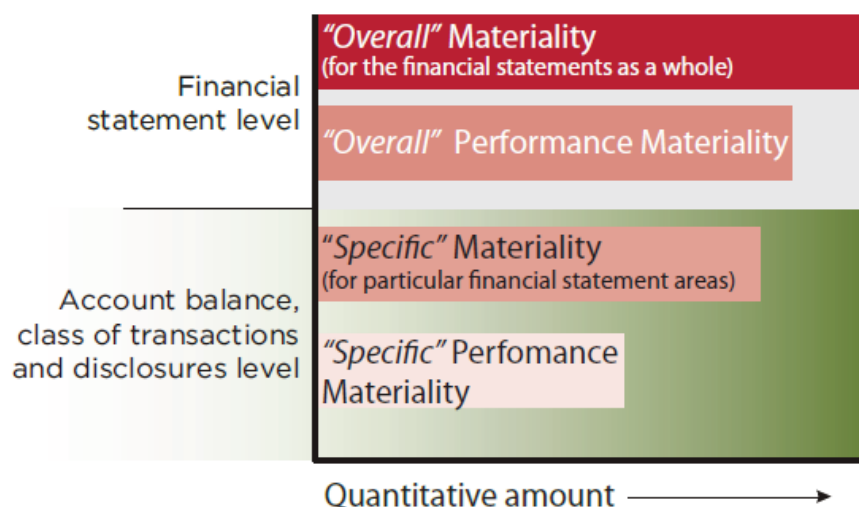
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# Materiality

## Different levels of materiality



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# Materiality

## Different levels of materiality

Materiality	Explanation
4. Clearly trivial	- It is clearly inconsequential, whether taken individually or in aggregate.
	- Misstatements above this threshold are accumulated so that the overall impact on the financial statements can be evaluated and communicated to those charged with governance.

**Materiality for the financial statements as a whole: HK\$500,000**

**Clearly trivial: HK\$25,000**

 **accumulated all misstatements > HK\$25,000 (no matter they are identified either by the auditor or by the client)**



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## Question:

**Materiality for the financial statements as a whole: HK\$500,000**

**Clearly trivial: HK\$25,000**

What happens if the total accumulated misstatements (with individual value > HK\$25,000) is greater than HK\$500,000?

- ❑ The engagement partner would discuss the matter with the client and request the client to adjust all misstatements found.
- ❑ If the client does not want to make the corrections, the engagement partner will be mindful as to which misstatements enhance or otherwise change the client's reported position and performance and will accept only a balanced set of differences.
- ❑ It is vital that the remaining uncorrected misstatements are not material individually or in aggregate.



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# Materiality

## Revision as audit progresses

Types of materiality	Revision as audit progresses
Overall materiality	<ul style="list-style-type: none"><li>• A change in circumstances that occurred during the audit such as the sale of part of the business</li><li>• New information</li><li>• A change in the auditor's understanding of the entity and its operations, as a result of performing further audit procedures</li></ul>
Performance materiality	<ul style="list-style-type: none"><li>• Changes in assessed risks</li><li>• Nature and extent of misstatements found when performing further audit procedures</li><li>• Change in understanding of the entity</li></ul>
Specific materiality	<ul style="list-style-type: none"><li>• A change in the special circumstances</li></ul>



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# Materiality

## Documentation

- The amounts for the various types of materiality levels
- The factors used in determining the different materiality levels
- Any revision of the materiality amounts as audit progress
- Reason for the revision of the materiality amounts



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# Materiality

## Reminder

- The determination of materiality requires the use of **professional judgment**. The suggested formula may NOT be applicable to all entities.
- All levels of materiality should be **approved by partners/managers** and communicated to the team members before the field work commences.
- Materiality for the financial statement as a whole is set to address the needs of financial statement users, it would not be changed as a **result of audit findings and changes in assessed risks**. While **performance materiality will change** under these circumstances.
- When **accepting a new audit engagement**, **inquire about the overall materiality** used by the previous auditor. This helps in determining whether further procedures are required on the opening balances.
- Make sure the financial information used to prepare the initial materiality during the planning phase is appropriate.



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# Materiality

## Exercise 5

DEF Limited is engaged in the manufacture and trading of textiles and apparels in the PRC. It has been operating with its present entity structure and its product range for several years. The entity has built a strong reputation in the market place based on its quality product range. The brand "*Simple*", targeted mainly at casual clothing for women, which represent 20 per cent of DEF's revenue, have come under heavy competition in the last 6 months, eroding DEF's profit margins on these products significantly.



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## Materiality

### Exercise 5(Cont'd)

Below is a summary of DEF's key financial data (in \$'m)

<u>Year</u>	<u>Revenue</u>	<u>Profit before tax</u>	<u>Total assets</u>	<u>Total equity</u>
20Y0	1,324	56	1,555	755
20X9	1,266	72	1,494	685
20X8	1,275	90	1,617	615
20X7	1,739	67	1,629	605

(a) You are the auditor of DEF Limited for the past 4 years. Determine and justify the benchmark and the percentage for calculating the overall materiality for the year ended 31 Dec 20Y0.

## Materiality

### Exercise 5 (Cont'd)

During 20Y2, the brand "*simple*" incurred significant loss and management disposed this product line to a third party with a total consideration of \$30m. The disposal met the requirements of HKFRS 5 and classified as "Discontinued operations". The loss for the discontinued operation presented on the financial statements was \$20m.

<u>Year</u>	<u>Revenue</u>	<u>Profit before tax</u>	<u>Total assets</u>	<u>Total equity</u>
20Y2	1,005	30	1,409	655

(b) Determine and justify the benchmark and the percentage for calculating the overall materiality for the year ended 31 Dec 20Y2.

# Materiality

## Exercise 6

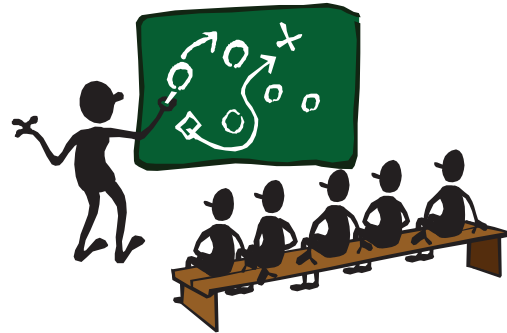
Flat Holding Company Limited is an investment property holding entity. It generates revenue by leasing out investment property to earn rental income. Please refer to an extract of the financial statements for the year ended 31 Dec 2010.

Determine and justify the benchmark and the percentage for calculating the overall materiality for the year ended 31 Dec 2010.



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# ***A Refresher Course on Current Auditing Standards 2013 (Day 1)***



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## **Agenda of today**

- 1. Preliminary engagement activities and overall audit strategy**
- 2. Understanding the entity and its environment**
- 3. Understanding and evaluating internal controls**
- 4. Financial statement assertions**
- 5. Materiality**
- 6. Risk identification, assessment and evaluation**
- 7. Risk assessment procedures**
- 8. Risk of fraud**



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# PART 6

## Risk Identification, Assessments and Evaluation



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### Risks

*Today's business world is constantly changing – it's unpredictable, volatile, and become more complex everyday. By its very nature, it is fraught with risk*

*In the current global economic environment, identifying, managing and exploiting risk across an organisation has become increasingly important to the success and longevity of any business*

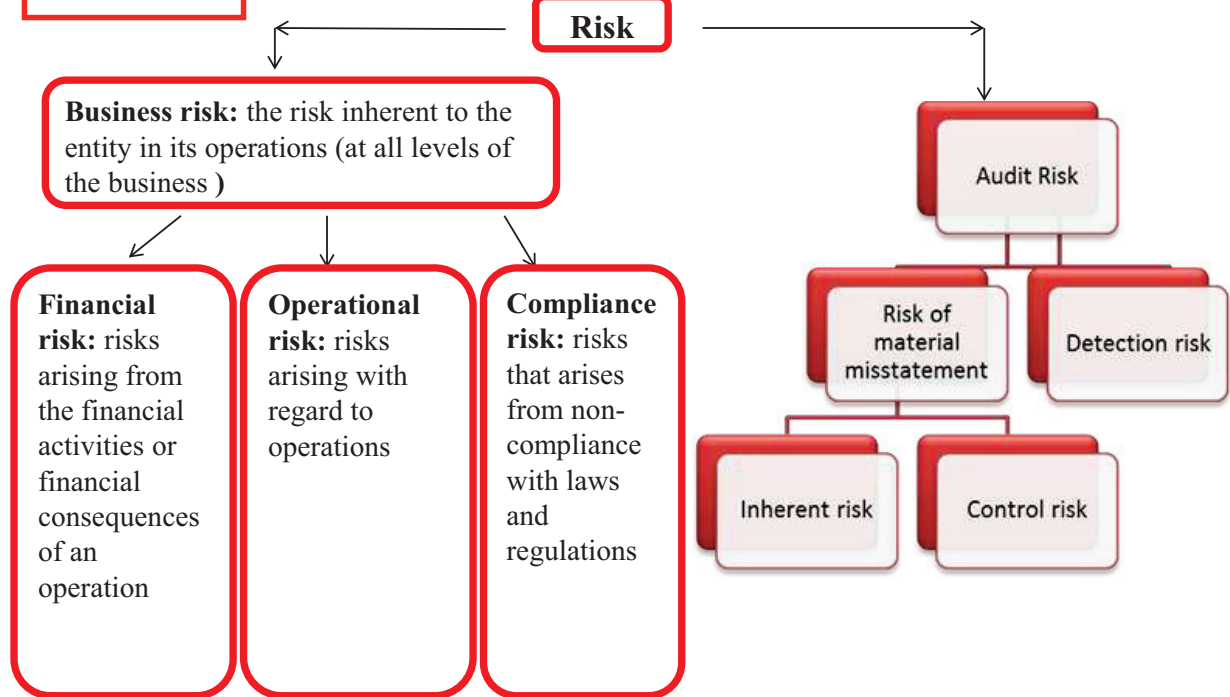


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# Risk



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# Audit risk



- Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.
- Audit risk has two key elements:

Risk of material misstatement (RoMM)

Risk that the financial statements are materially misstated prior to the start of any audit work

Detection risk (DR)

Risk that audit procedures performed do not detect a misstatement(s) that could be material individually or in total

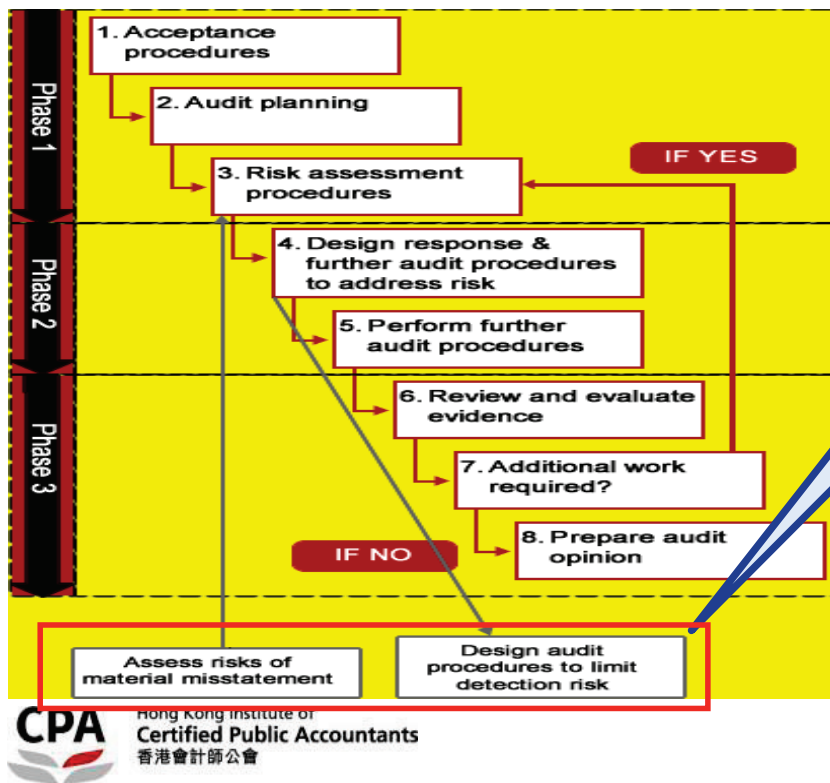


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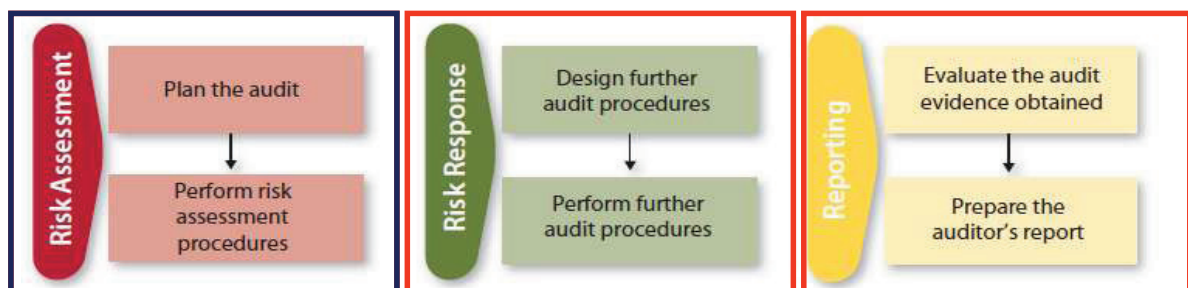
## RoMM and Detection Risk



For the auditor to be able to reduce audit risk to an acceptable level, the auditor needs to :

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## The risk-based audit



In conducting an audit of financial statements, the overall objectives of the auditor are:

To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework



## Risk Identification and Assessments

Three key standards that define the audit approach under the **Auditing Standards**....

- **HKSA 315:** *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment;*
- **HKSA 330:** *The Auditor's Responses to Assessed Risks;* and
- **HKSA 240:** *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*



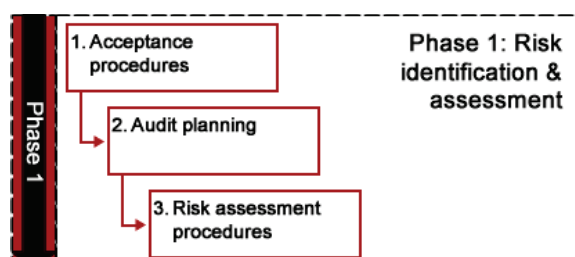
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## Risk Identification and Assessments

- **HKSA 315** requires that an auditor:
  - should identify and assess the risks of material misstatement (RoMM) whether due to fraud or error at the **financial statement** and **assertion** level; and
  - has a thorough understanding of the entity including its internal control environment
- Once this is performed, the auditor is in a position to respond to these assessed risks and decide what procedures need to be done to keep audit risk to an acceptable level
- The auditor must understand more about the component parts of RoMM and what information will help identify and assess the risks.

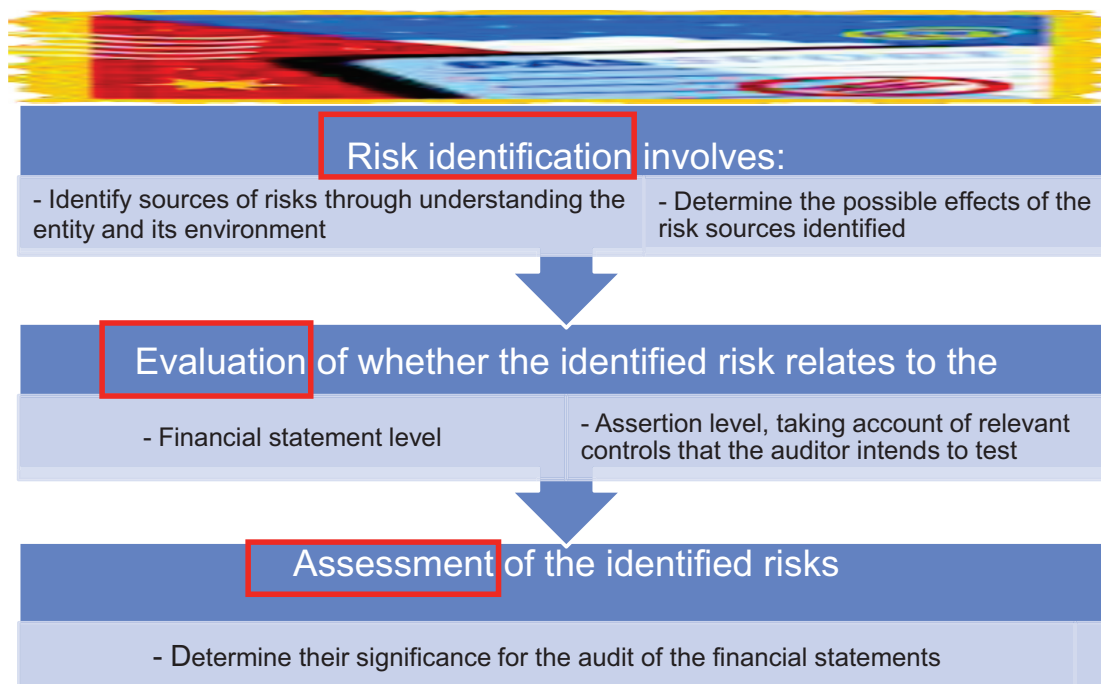


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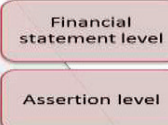
## Risk management – three step process



## Financial statement level risks



How to evaluate whether the identified risks relate to financial statement level or assertion level?

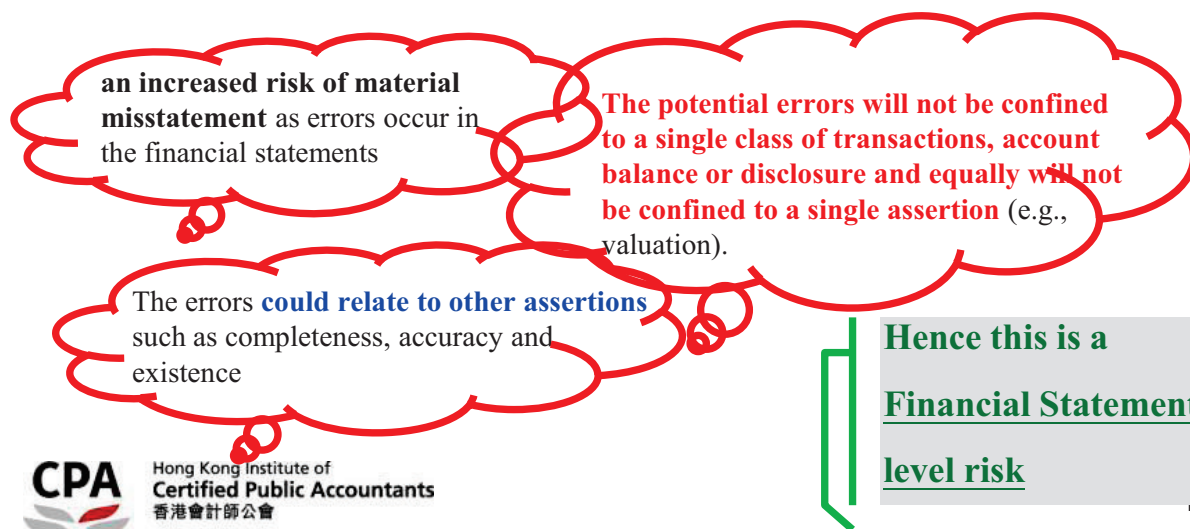


**Risk of material misstatement at the financial statement level relate more pervasively to the financial statement as a whole and potentially affect many assertions**

# Financial statement level risks

## Scenario based example

The senior financial controller of Company X has been off work with illness for six months, and you are concerned that their replacement is not sufficiently competent for the role - what could the potential impact be on the financial statements?



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## Financial statement level VS Assertion level

### Financial statement level

- More pervasive to the financial statement as a whole
- Affect many assertions
- Risks from deficient control environment / controls
- Aggressive business strategies
- Significant business risk, e.g. fraud
- Complexity of business operation
- High pressure on performance measures and reviews
- Concern about going concern

### Factors to consider

- Management integrity
- Management experience and knowledge
- Unusual pressures
- Nature of business
- Industry factors, e.g. special regulations

### Assertion level

- Refer to specific classes of transactions, account balances or disclosures
- Identify controls that are likely to prevent, detect or correct material misstatement
- Comprises of inherent risk and control risk

### Factors to consider

- Accounts susceptible to misstatements
- Complexity of underlying transactions
- Degree of judgment involved in determining account balances
- Susceptibility of assets to loss
- Completion of unusual transactions near the year end

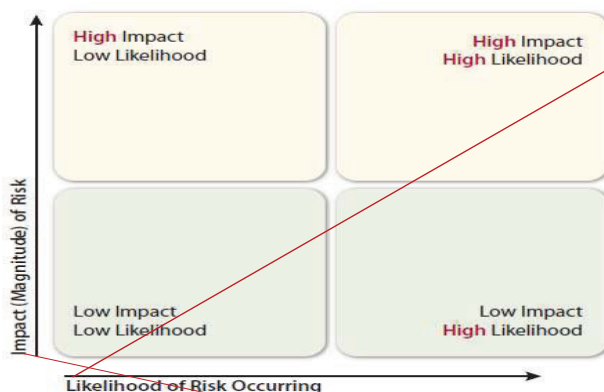


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## Significance of risks



*What are significant risks? What are the factors for consideration when assess risks?*



- **Likelihood of a misstatement occurring** – evaluate the probability simply as high, medium or low

- **Magnitude (Monetary impact) if the risk did occur** – assess the impact against a specific amount that relate to what constitute a material misstatement for the financial statements as a whole. Again, evaluate the impact as high, medium or low

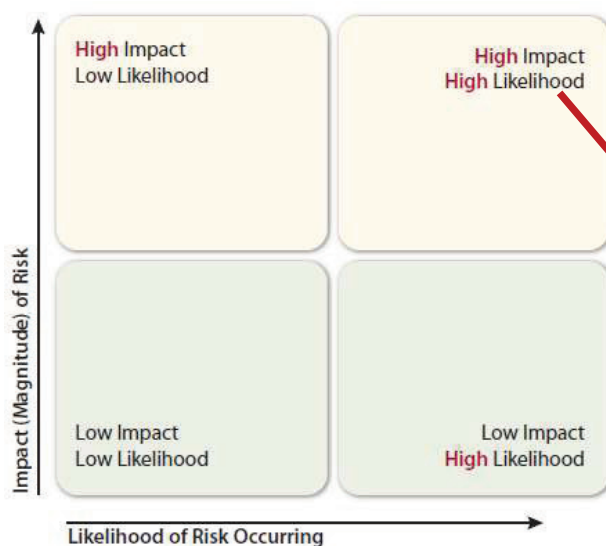


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## Classification of risks and significant risk



- These risks require management action to mitigate

- They will also likely be determined as **significant risks**



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# Classification of risks and significant risk

## Scenario example

A company with a large inventory of diamonds will have a high inherent risk of theft. However management is likely to have very strong security arrangements. For that reason if control risk were included, the combined risk would be small. Would the risk of loss be deemed to be significant?



# Classification of risks and significant risk

## Significant risks

- An identified and assess risk of material misstatement that, in the auditor's judgment, **requires special audit consideration**
- Assessed before consideration of any mitigating controls and is **based on the inherent risk only** and not the combined risk with internal control risk factored in



# Classification of risks and significant risk

## Further examples:

**Inherent risk** may be higher than normal:

- if a company is planning to **list on the local stock exchange** within a couple of years because there may be an incentive to manipulate figures in order to attract investors
- if a company is **facing financial difficulties** and is seeking alternative finance, as there may be an incentive to manipulate figures to attract finance
- if a company **operates a profit related pay scheme**, as management may be motivated to ensure that financial targets are reached through manipulating the figures
- if a company **operates a cash-based business**, as there may be higher risk that cash goes missing from sites

## Significant risk

**HKSA 315.28 specifies some specific risk types that should always be treated as significant risks**

In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

- Whether the risk is a **risk of fraud**
- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention
- The **complexity of transactions**
- Whether the risk involves **significant transactions with related parties**
- The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a **wide range of measurement uncertainty**; and
- Whether the risk involves **significant transactions that outside the normal course of business** for the entity, or that otherwise appear to be unusual

## Classification of risks and significant risk

Significant risks can often relate to the matters outlined below in smaller entities :

<b>Significant non-routine transactions</b>	<ul style="list-style-type: none"><li>• High inherent risk (likelihood and impact)</li><li>• Transactions that occur infrequently and are not subject to systematic processing</li><li>• Unusual due to their size or nature</li><li>• Involve complex calculations or accounting principles</li><li>• Require management intervention:<ul style="list-style-type: none"><li>- to specify accounting treatment, and</li><li>- for data collection and processing</li></ul></li></ul>
<b>Significant judgemental matters</b>	<ul style="list-style-type: none"><li>• High inherent risk</li><li>• Involve significant measurement uncertainty</li><li>• Accounting principles involved may be subject to differing interpretation (e.g. revenue recognition)</li><li>• Management judgement is subjective, complex or require assumption about the effects of future events e.g. valuation</li></ul>

## Classification of risks and significant risk

Significant risks can often relate to the matters outlined below in smaller entities (cont'd) :

<b>Significant transactional risks</b>	<ul style="list-style-type: none"><li>• Transactional risks relating to major business processes (such as goods being shipped but not invoiced in a sales process) that would result in a material misstatement in the financial statements if not mitigated</li><li>• If there were no internal controls in place to mitigate such risks, they would also be reported to management as being as significant deficiency</li></ul>
<b>Fraud</b>	<ul style="list-style-type: none"><li>• Revenue recognition</li><li>• Management override of controls</li><li>• Major related party transactions used to increase sales</li><li>• Collusion with suppliers or customers such as price or bid rigging</li><li>• Unrecorded or fictitious transactions</li></ul>



## Identification, evaluation and assessment of risks of material misstatements...



Time for fun...

- Please refer to Exercise 7 for background information....



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## PART 7

### Risk assessment procedures



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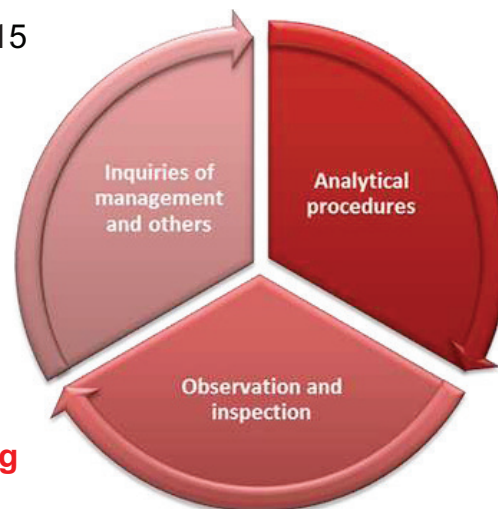
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## Risk assessment procedures

- The auditor needs to use risk assessment procedures in order to identify and assess the risks of material misstatement. HKSA315 *Identifying and assessing the risks of material misstatement* requires that the auditor should include the procedures shown
- Applying these procedures will enable the auditor to understand the entity and its environment including internal control. These procedures will continue throughout the audit as more information is gathered, updated and analysed. **Obtaining an understanding of the entity is a continuous, dynamic process**

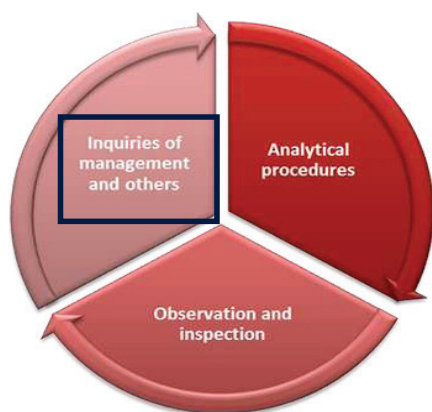


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## Inquiries of management and others



Though the auditor is most likely to make inquiries with management, inquiries made to others will provide insights into the potential for other risks that may have been missed

Others	How may inquiries be useful?
TCWG	Provides information about the environment in which financial statements are prepared
Internal audit	Provide information on internal audit procedures performed relating to the design and effectiveness of the entity's internal control and management's responses
Employees involved in complex transactions	Helps auditor assess appropriateness of selection and application of certain accounting policies
In house legal counsel	Provides information about litigation, knowledge of fraud or suspected fraud, warranties, contract interpretations
Marketing or sales staff	Provides an insight into changes in marketing strategy, sales trends, contractual arrangements with customers etc



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## Inquiries of management and others

Do not confine your questions (especially in smaller audits) to the owner-manager and the accountant

Ask other employees (if any) in the entity about trends, unusual events, major business risks, the functioning of internal control and any instances of management override

If possible fraud involving senior management or TCWG is discovered, consult immediately with the engagement partners. Consider obtaining legal advice. Keep information confidential. Check the code of ethics for any additional requirements and guidance

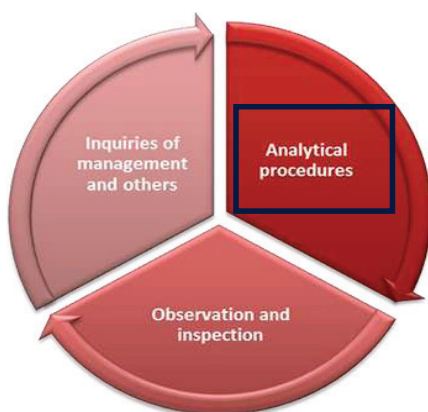


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## Analytical procedures (AP)



- Analytical procedures are procedures that compare financial information and consider reasonableness of relationships between different data. They can include both financial and non-financial information
- These procedures can be used to identify aspects of the entity of which the auditor was unaware e.g., unusual transactions or events, amounts, ratios or trends that may have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risk of material misstatements particularly due to fraud
- However as they are generally performed at a high level, at this stage, they only provide a broad initial indication of a potential risk of material misstatement and should be used together with other information gathered



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## Analytical procedures as risk assessment procedures

### What To Do?

- Identify relationships within data
- Compare information obtained (both financial and non-financial) to other sources, e.g. industry statistics, budget, forecast etc
- Identify risks and design responses

### How To Do?

- Develop expectations about plausible relationships among the various types of information
- Where possible, use independent source of information
- Compare expectations with recorded amounts / ratio
- Ratio analysis, e.g. stock turnover days, debtors days
- Identify any unusual relationships and investigate

### Where to Find?

- Management accounts / ledgers / breakdown
- Interim financial information
- Budgets/forecasts
- Industry information
- Non-financial information



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## Preliminary Analytical Procedures



### Case: Hong Kong Bauhinia Development Limited (Exercise 7A)

- Have you performed preliminary analytical procedures as part of your risk assessment procedures?

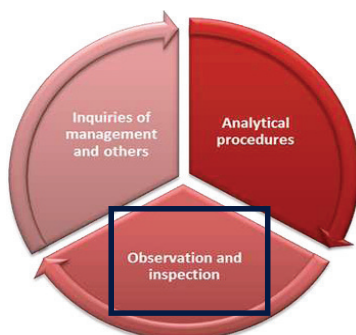


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## Observation and inspection



- support inquiries of management and others; and
- provide additional information about the entity and its environment

Procedure	Some potential application
<b>Observation</b>	<ul style="list-style-type: none"> <li>• How the entity operates and is organized</li> <li>• Entity's premises and plant facilities</li> <li>• Operation of various internal control procedures</li> <li>• Compliance with key policies</li> </ul>
<b>Inspection</b>	<ul style="list-style-type: none"> <li>• Business plans, strategies, and proposals</li> <li>• Industry studies and media reports</li> <li>• Major contracts and commitments</li> <li>• Regulations and correspondence with regulators</li> <li>• Correspondence with lawyers, bankers, and other stakeholders</li> <li>• Accounting policies and records</li> </ul>

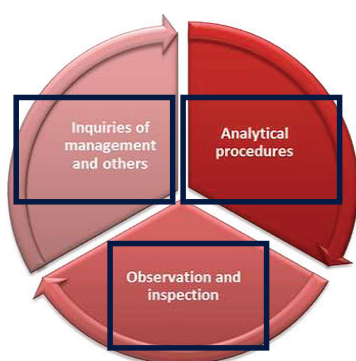


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## Relationship between the risk assessment procedures



The auditor needs to perform the three risk assessment procedures shown, but doesn't need to perform each of them for each aspect of understanding required. Often the results from performing one type will lead to performing another type.

### Illustrative example

- An auditor may **interview** a sales manager
- During the interview an unusual sales contract is identified which is significant in size
- The auditor follows up by **inspecting** the actual sales contract
- The auditor follows up by performing **analytical procedures** on sales margins for evidence of other unusual terms



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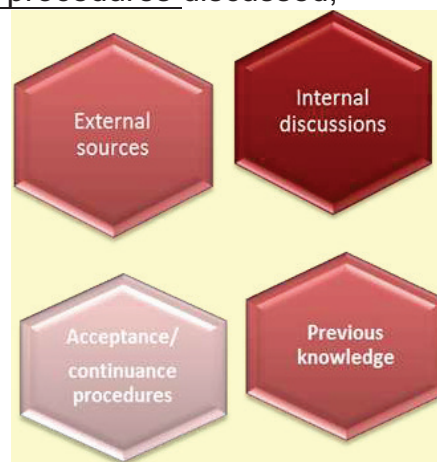
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## Other procedures

In addition to using the three risk assessment procedures discussed, the auditor **may** use other procedures e.g.,

- reviewing information from external sources such as trade/economic journals, analyst, banks, rating agencies and regulatory publications
- discussing internally with key staff at audit team discussions
- referring to information obtained when performing client acceptance and continuance procedures
- referring to information obtained from previous audit of the entity e.g. history of poor controls, past misstatements etc.



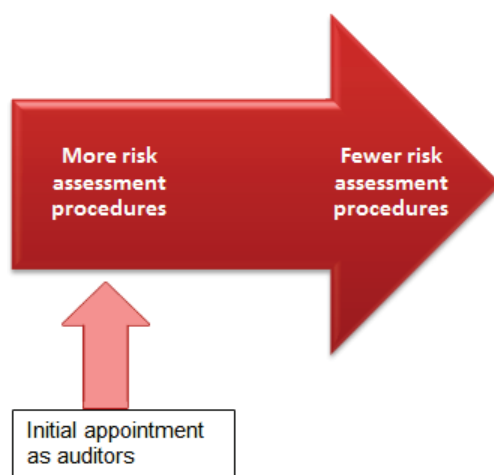
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## Risk assessment

### First year engagement



- If it is the first year that an auditor is performing the audit for an entity, in order to obtain a proper understanding of the entity to identify and assess risks, a significant amount of time must be spent
- This may involve communications with previous auditors, review of acceptance procedure risk assessments, as well as the additional enquiries and documentation of controls that will need to be undertaken
- If this is performed and documented well in the first year of the audit, the time required to update the information in subsequent years will be considerably less than in that first year



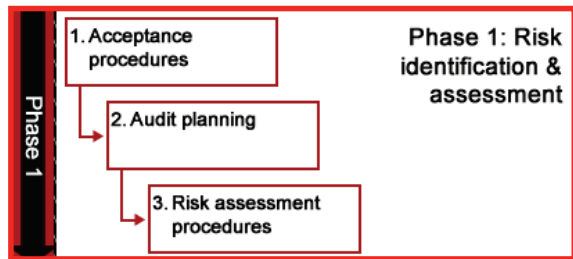
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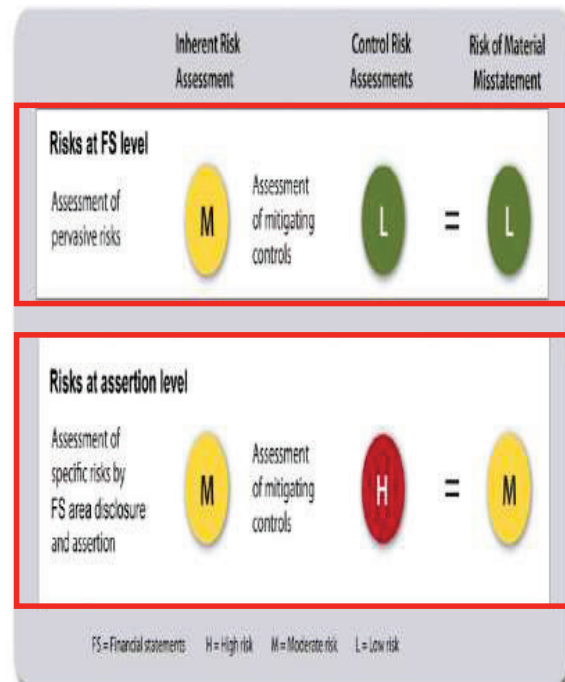
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## Concluding risk assessment



With both inherent and control risks identified, the auditor is able to assess a combined risk of material misstatement. The resulting list of assessed risks will form the foundation for **the next phase in the audit, which is to determine how to respond appropriately to the assessed risks through the design of audit procedures**



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## Risk assessment

### Reminders:

- ✓ **Determination of risk of material misstatement is a matter of professional judgment**
- ✓ **Risk assessment does not end at a point in time. Original assessment may be revised as audit progresses**
- ✓ **Risk assessment procedures will NEVER provide sufficient appropriate evidence on their own on which to base the audit opinion**
- ✓ **The evidence obtained from risk assessment procedures must be supplemented by further audit procedures that respond to the risks identified**

# PART 8

## Risk of fraud

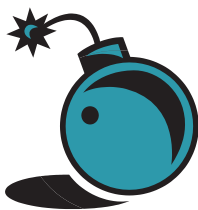


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## What is Fraud?



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

**Error:** Normally an **unintentional** misstatement in financial statements, including the omission of an amount or a disclosure



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## Risk of fraud

### Responsibility of prevention and detection of fraud and error

The **primary responsibility** for the prevention of fraud and error rests with both those charged with governance of the entity and with management



- Establishing a control environment and maintaining policies and procedures
- Following the recommendations from different regulatory or professional organisations
- Developing a code of conduct and creating an ethical culture
- Establishing an internal audit function



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## Risk of fraud

**What is the auditor's responsibility towards the risks of fraud in financial statements?**



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## HKSA 240 and HKSA 315

- **HKSA 240** *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements* requires that, in planning and performing the audit to reduce audit risks to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud
- **HKSA 240** also requires that the auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance
- **HKSA 315:** *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* require that the auditor should obtain an understanding of the entity and its environment, including its internal controls, sufficient to identify and assess the risks of material misstatement of financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures



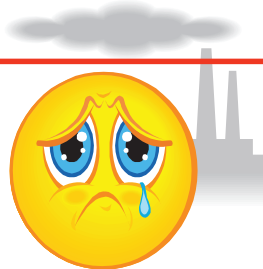
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## Risk of fraud

**What is the auditor's concern in respect of the risks of fraud?**



**The auditor is concerned with fraud that causes a material misstatement in the financial statements**



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## Two types of fraud causing material misstatements in financial statements include:

Types of fraud	Examples
<b>Fraudulent financial reporting</b> – intentional misstatements to deceive financial statement users	<ul style="list-style-type: none"> <li>• Omissions of amounts or disclosures</li> <li>• Recording fictitious journal entries</li> <li>• Manipulation or alteration of accounting records or other documentations, such as inappropriate revenue recognition, accruals and provision made at year end</li> <li>• Concealing important information</li> <li>• Engaging in complex transactions, leading to inability to collect audit trail</li> </ul>
<b>Misappropriation of assets</b> – wrongful taking of an entity's assets	<ul style="list-style-type: none"> <li>• Embezzling receipts (e.g. diverting them to private bank accounts)</li> <li>• Wrongfully taking possession of physical non-current assets or intellectual property for personal use or to sell on</li> <li>• Creating false ledger or payroll entries to cause an entity to pay for goods which have not been ordered or received</li> <li>• Using an entity's assets as collateral for a personal loan or loan to a related party</li> </ul>



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## Fraud risk factors

**Fraud risk factors** may be defined as any conditions or circumstances that may increase the risks of fraud



As part of the risk assessment procedures required by HKSA 315, the auditor should consider whether one or more fraud risk factors are present in order to identify the risks of material misstatement due to fraud



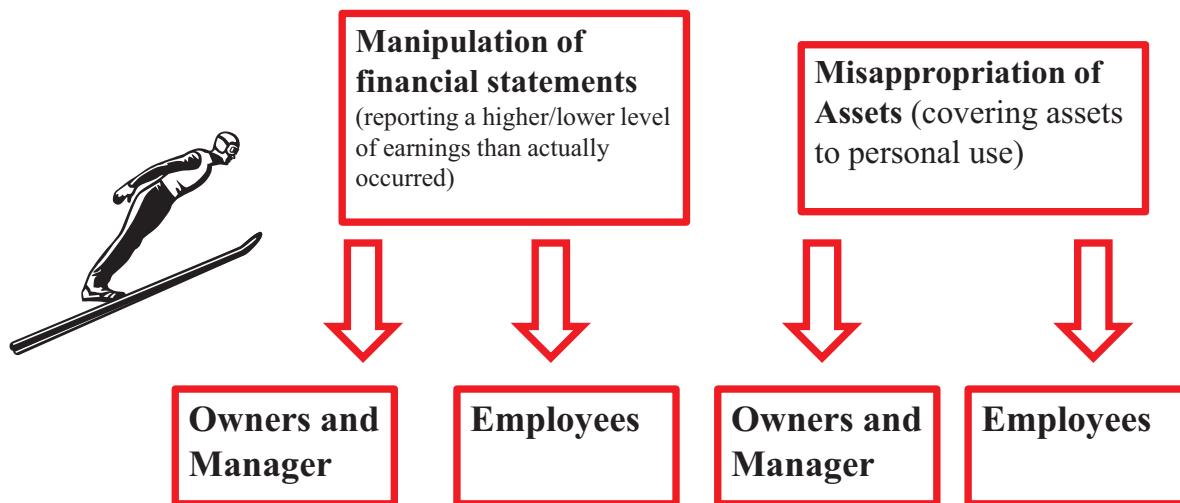
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## Fraud risk

### Who?



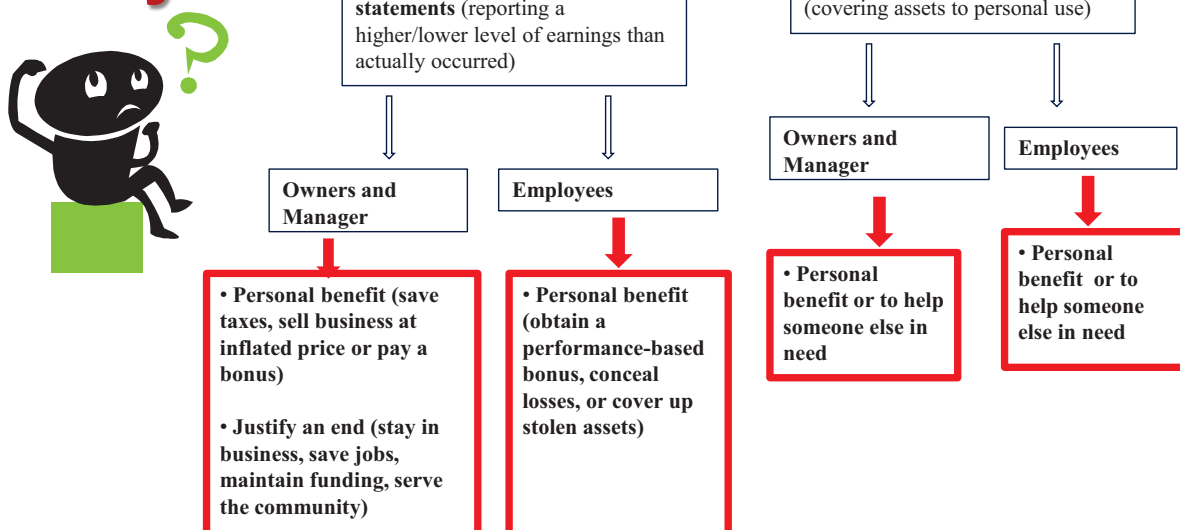
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## Fraud risk

### Why?



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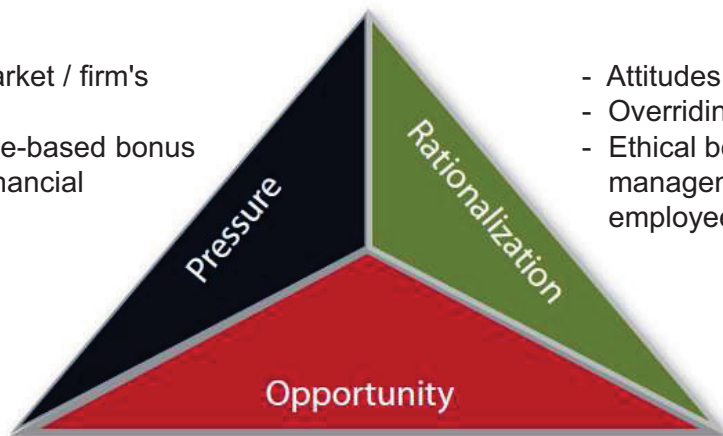
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## Conditions present when fraud exists

The Fraud Triangle – existence of the three conditions that often provide clues to the existence of fraud

- Meeting market / firm's expectation
- Performance-based bonus
- Personal financial obligations



- Attitudes of management
- Overriding existing controls
- Ethical behaviors of management and employees

- Lack of adequate internal controls
- Poor corporate culture
- Assets susceptible to misappropriation



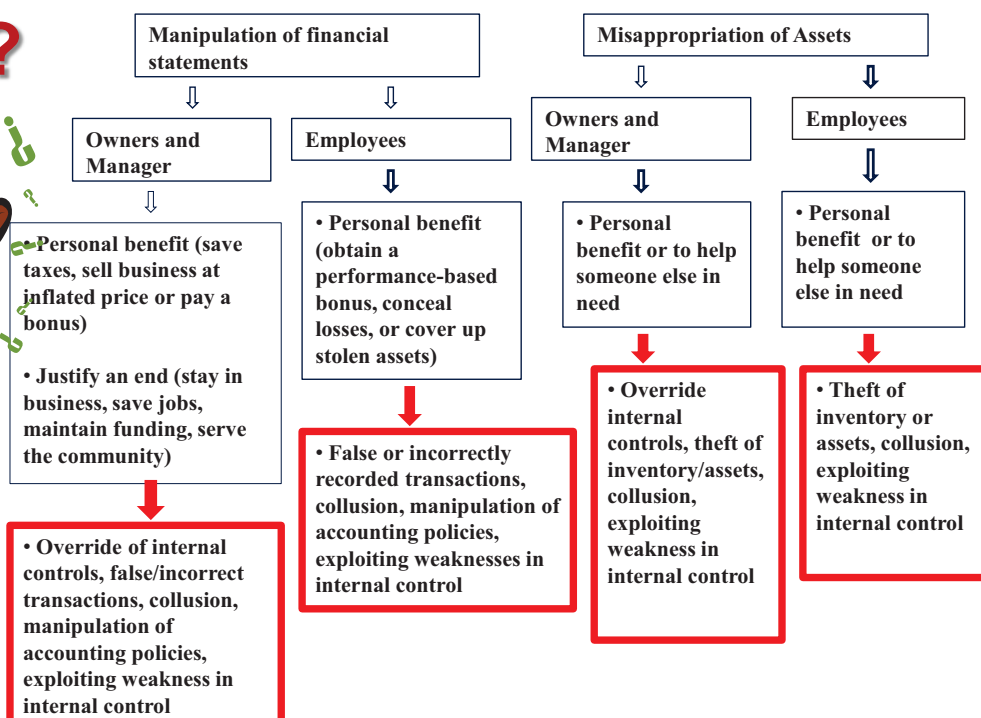
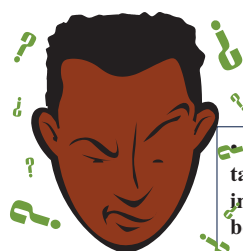
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## Fraud risk

How?



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# Risk of fraud

Although fraud can occur at any level in the organisation, it tends to be more serious when senior management is involved

Some of the major conditions that create an environment for fraud include:

- **Ineffective corporate governance**
- **Lack of leadership** by management and poor "tone at the top"
- High incentives provided for **financial performance**
- **Taxes** or other expenses that are **very high or onerous**
- **Complexity** in the entity's rules, regulations and policies
- **Unrealistic expectations** from bankers, investors, or other stakeholders
- **Downward and unexpected shifts in profitability**
- **Unrealistic budget targets** for staff to attain
- **Inadequate internal control**



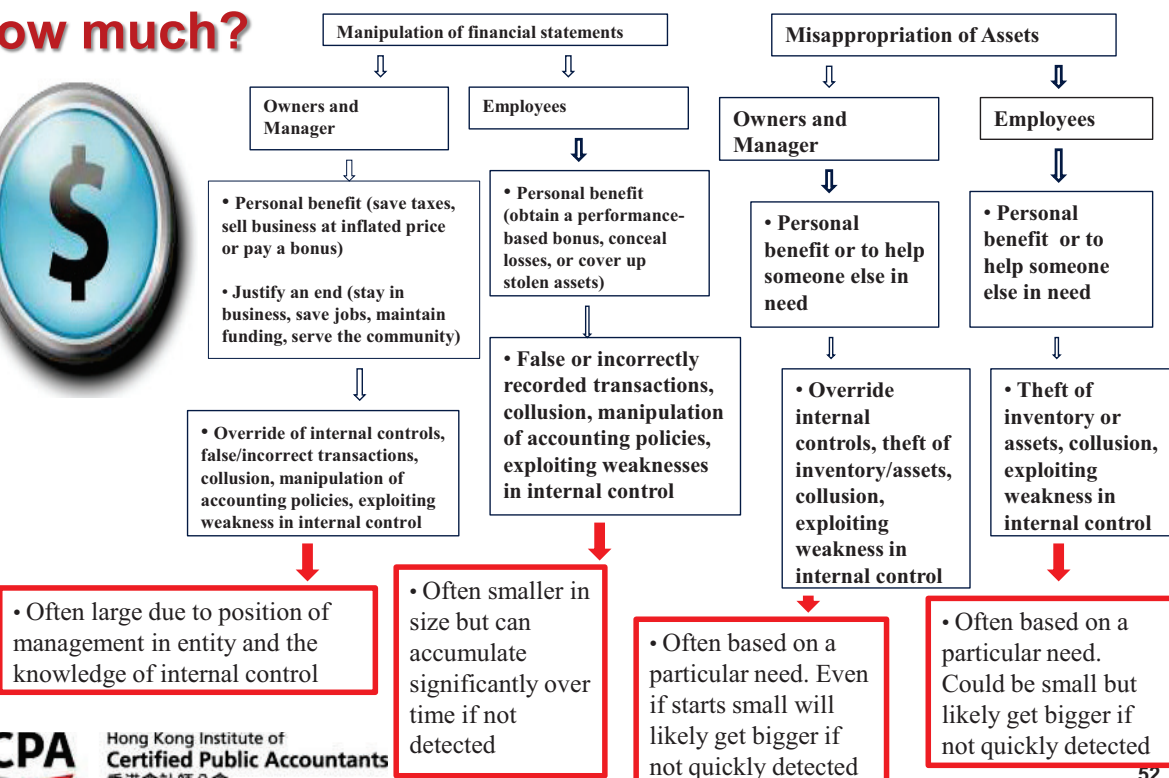
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# Fraud risk

How much?



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## Risk of fraud

### Scenario:

- ✓ ABC Ltd is a company incorporated in Hong Kong
- ✓ ABC's business was very successful during the period 2010 to 2012, and most of its customers are financial institutions based in the US
- ✓ Ms. Chan is a CPA (Practising) and has just started planning the audit of ABC's financial statements for the year ended 30 June 2013

### Scenario (cont'd):

- Mr. Lee, the Chief Executive Officer of ABC, has discussed the following matters with Ms. Chan:
  - ✓ 1) Notwithstanding the US sub-prime mortgage crisis, Mr. Lee does not think customers in the US will have any difficulties in settling trade debts. However, a general allowance at 1% of the outstanding balance has been maintained as a contingency reserve against losses from bad and doubtful debts
  - ✓ 2) Mr. Lee provides certain figures from ABC's accounting records to Ms. Chan (refer to Exercise 8)
  - ✓ 3) Mr. Lee expects ABC to be ready for listing on the Hong Kong Stock Exchange in the near future in order to stay competitive
  - ✓ 4) Mr. Lee explains that ABC has recently changed the remuneration package for senior managerial staff linking it more directly to ABC's sales
  - ✓ 5) Mr. Lee explains that ABC has recently established an affiliated entity in the US to provide certain support services for ABC's main products

## Fraud risk factors relating to ABC Ltd



What are the fraud risk factors identified from the audit of ABC's financial statements for the year ended June 30 2013 ?

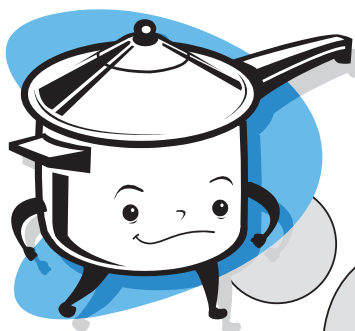


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## Fraud risk factors relating to ABC Ltd



- **Pressure from the US sub-prime mortgage crisis** – the financial stability of ABC is threatened by the US sub-prime mortgage crisis. Over 80% of ABC's sales are from customers in the US (financial institutions). Its business is therefore vulnerable to the downturn in the general economy and financial services sector in the US



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## Fraud risk factors relating to ABC Ltd



- **Pressure for a listing** – there is a risk of excessive pressure on ABC's management to meet the requirements or expectations for a listing on the Hong Kong Stock Exchange in the near future in order to stay competitive

- **Incentive to meet sales targets** – there is a risk of excessive incentives for ABC's senior managerial staff to meet financial targets established under the new remuneration package, i.e., the more direct link to sales

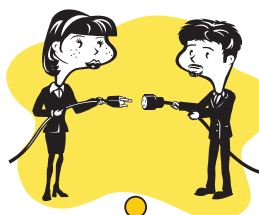


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## Fraud risk factors relating to ABC Ltd



- **Opportunity for increasing related-party transactions** – As an affiliated entity has recently been established in the US supporting ABC's main products, there is a risk of significant increase in related-party transactions with related entities not audited or audited by another firm



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## Fraud risk factors relating to ABC Ltd

- **Overly optimistic attitude of the CEO** – Despite the slowdown in the US economy (and the US sub-prime mortgage crisis), Mr. Lee's attitude to ABC's business appears to be overly optimistic, and Ms. Lee does not appear to have discussed any strategies openly with Ms. Chan



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Refer to Annex 7 for the fraud risk factors in the Appendix 1 of HKSA 240



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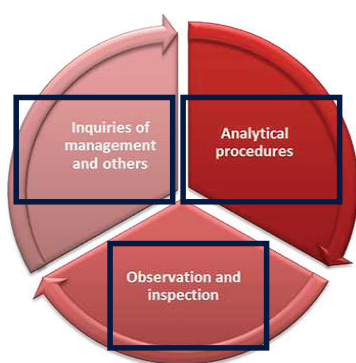
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## Fraud risk assessment

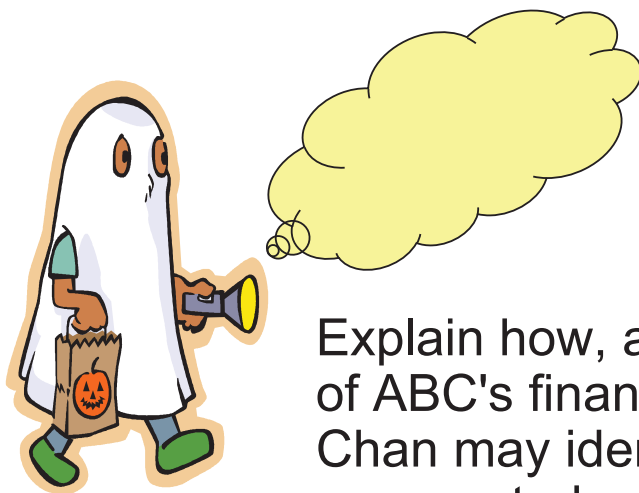
- **Discuss** among the team members about the susceptibility of the financial statements to fraud
- **Evaluate** whether any fraud risk factors exist
- **Inquiries** of management regarding:
  - a) Management's fraud risk assessment
  - b) Management's process for identifying and responding to fraud risks
  - c) Management's communication to TCWG regarding (b) above
  - d) Management's communication to employees regarding its views on business practices and ethical behavior
- **Inquiries** of management and others (e.g. internal audit) any knowledge about any actual, suspected or alleged fraud
- **Evaluate** whether any audit findings indicate risk of material misstatement due to fraud, e.g. unusual / unexpected relationships identified in analytical procedures

## Risk assessment procedures



As part of the risk assessment procedures required by HKSA 315, Ms. Chan should **consider any unusual or unexpected relationships that have been identified in performing analytical procedures**

Analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications



Explain how, as part of the audit of ABC's financial statements, Ms. Chan may identify any unusual or unexpected relationships among the figures provided by Mr. Lee that may indicate risks of misstatement due to fraud

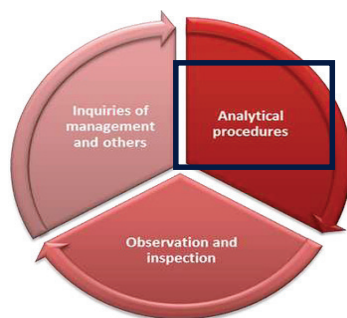


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## Inquiries of management and others



Ms. Chan may carry out **analytical procedures on sales and trade receivables** with the objective of identifying unusual or unexpected relationships that may indicate risks of material misstatement due to fraudulent financial reporting, e.g. fictitious sales or concealment of irrecoverable trade debts

How	June 30, 2013	June 30, 2012
Debtor turnover days	US customers days = <b>89.6 days</b> Other customers = <b>39.8 days</b>	US customers = <b>73 days</b> Other customers = <b>36.5 days</b>
Sales	\$165M	\$150M
<b>Remarks:</b> US customers (comprise over 80% of ABC's sales) have taken much longer to pay compared to other customers. Against the background of the economic crisis, may indicate ABC's US customers have experienced financial difficulties  Sales from the US customers and the other customers have both increased by 10% from 2012 to 2013. Against the background of the US economic situation, may need to question the increase in sales to financial institutions in the US		



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## Fraud risk assessment

There are **TWO presumed significant risks** as required under HKSA 240

### 1) Fraudulent revenue recognition

- Evaluate which types of revenue, revenue transactions or assertions give rise to such risks
- If the auditor concludes that **the presumption is not applicable** in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud, **document the reason for that conclusion**
- For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property



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## Fraud risk assessment

There are **TWO presumed significant risks** as required under HKSA 240.  
(cont'd)

### 2) Management override of controls

- Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively
- Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities
- Therefore, **this presumption cannot be rebutted**



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# Risk of fraud

## Risk responses

The auditor shall identify and assess the risks of material misstatement due to fraud

- at the financial statement level; and
- at the assertion level

## Overall responses

Financial statement level	Assertion level
<ul style="list-style-type: none"><li>➤ Assign and supervise staff according to their skill, knowledge and ability, i.e. individual with <b>specialised skills</b></li><li>➤ Increase <b>professional skepticism</b></li><li>➤ Evaluate <b>accounting policies</b></li><li>➤ Incorporate <b>unpredictability tests</b></li></ul>	<ul style="list-style-type: none"><li>➤ Change the <b>nature</b> of audit procedures</li><li>➤ Change the <b>extent</b> of audit procedures</li><li>➤ Change the <b>timing</b> of audit procedure</li></ul>



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# Risk of fraud

**Professional skepticism** includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the HKSAs.

This reduces the risks of:

- ✓ Overlooking unusual circumstances.
- ✓ Over generalizing when drawing conclusions from audit observations.
- ✓ Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.



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## Risk of fraud

### Risk responses – management override of controls

Areas	Procedures
<b>Journal entries</b>	Test the appropriateness of journal entries recorded in the general ledger and other adjustments when preparing the financial statements. (a) Enquire individuals involved in financial reporting process about inappropriate or unusual activity relating to journal entries and other adjustments preparation (b) Select journal entries and other adjustments made at the end of a reporting period (c) Consider the need to test journal entries and other adjustments throughout the period
<b>Accounting estimates</b>	Review estimates for biases and whether it represents a risk of material misstatement due to fraud. (a) Evaluate whether judgements and decisions made by management indicate a possible bias. If so, re-evaluate accounting estimates taken as a whole. (b) Perform a retrospective review of management judgements and assumptions related to prior year's significant accounting estimates



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## Risk of fraud

### Risk responses – management override of controls (cont'd)

Areas	Procedures
<b>Significant transactions</b>	For significant transactions outside the normal course of business or appear to be unusual, (a) Evaluate whether the business rationale suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.
<b>Other audit procedures</b>	In addition to those specifically referred to above, the auditor determine and perform other audit procedures to respond to the identified risks of management override of controls.



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# Risk of fraud

## Reporting

### 1) Evaluation of audit evidence for indication of fraud

- Final analytical procedures
  - Identified misstatements
- ⇒
- if there is such indication and that management is involved, re-evaluate the fraud risk assessment and its resulting impact on the nature, timing and extent of audit procedures,
  - Consider if there is possible collusion involving employees, management or third parties

If the auditor's consider it is unable to continue the engagement,

- determine the professional and legal responsibilities, whether there is a requirement to report to the person(s) who made the audit appointment or, to regulatory authorities;
- consider whether withdrawal is possible under applicable law or regulation.



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# Risk of fraud

## Reporting (cont'd)

### 2) Written representation from management

- (a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;
- (b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;
- (c) They have disclosed to the auditor their knowledge of fraud, or suspected fraud, affecting the entity involving:
  - (i) Management;
  - (ii) Employees who have significant roles in internal control; or
  - (iii) Others where the fraud could have a material effect on the financial statements; and
- (d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.



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# Risk of fraud

## Reporting (cont'd)

### 3) Communication on fraud matters

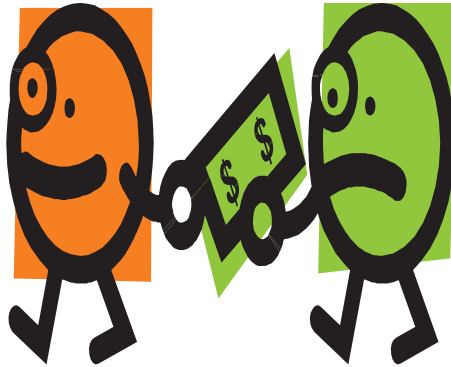
- Appropriate level of management and those charged with governance ("TCWG")
- Regulatory and enforcement authorities

# Risk of fraud

## Documentation

- Engagement team discussion – significant decisions reached regarding the susceptibility of the entity's financial statements to material misstatements due to fraud
- Identified and assessed risk of fraud
- Risk responses and the results of audit procedures
- Communication with management, TCWG, regulators and others
- Reasons for rebutting the presumption that there is a risk of material misstatement due to fraud related to revenue recognition.





Is the auditor responsible for detecting any kind of fraud that may have occurred?

- Absolutely not. The auditor's responsibility relates to the detection of material misstatements caused by fraud and is not directed to the detection of fraudulent activity per se.
- Thus, the auditor of financial statements must obtain reasonable assurance that the statements are free of material misstatements, whether caused by error or fraud



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Thank you for your attention

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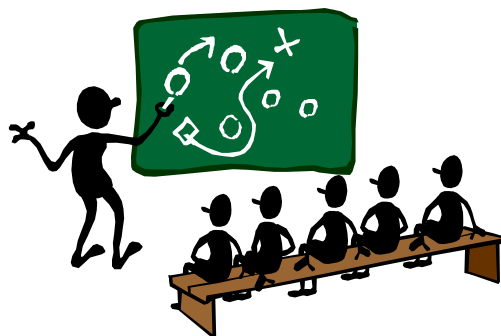
## **A Refresher Course on Current Auditing Standards**

### **Day 2**

<b>Time</b>	<b>Topic</b>
8:30 - 9:00	Registration
9:00 - 9:30	Recap on audit planning and risk assessment
9:30 - 10:15	Response to assessed risks
10:15 - 11:00	Further audit procedures in general
11:00 - 11:15	Break
11:15 - 12:00	Analytical procedures
12:00 - 12:45	Audit sampling
12:45 - 13:45	Lunch
13:45 - 14:45	External confirmation
14:45 - 15:30	Related parties
15:30 - 15:45	Break
15:45 - 17:00	Audit of accounting estimates, including fair value accounting estimates and disclosures

Presented by : Winnie Chan, Associate Director, Technical Learning and Support, HKICPA  
Eky Liu, Manager, Technical Learning and Support, HKICPA  
Venue: The Hong Kong Institute of Certified Public Accountants

# ***A Refresher Course on Current Auditing Standards 2013 (Day 2)***



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## **Agenda of today**

- 1. Recap on audit planning and audit risk assessment**
- 2. Response to assessed risks**
- 3. Further audit procedures in general**
- 4. Analytical procedures**
- 5. Audit sampling**
- 6. External confirmation**
- 7. Related parties**
- 8. Audit of accounting estimates, including fair value accounting estimate and disclosures**



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# PART 1

## Recap on audit planning and audit risk assessment



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## Recap on audit planning and audit risk assessment

### Questions:

1. Are the following statements true or false?

#### Statement 1

An auditor may accept a new client even if there is a threat to independence

#### Statement 2

An auditor may accept a new client evaluated as being high risk



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## Recap on audit planning and audit risk assessment

### Questions:

2. Are the following statements true or false?

#### Statement 1

Terms of an audit engagement must be formalised in a prescribed format known as an audit engagement letter

#### Statement 2

There is no prescribed date that the engagement letter should be sent out by



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## Recap on audit planning and audit risk assessment

### Questions:

3. How often should an engagement letter be updated and re-issued?

- a. Every year
- b. When circumstances change
- c. If the auditor needs to remind the entity of terms
- d. Every three years



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## Recap on audit planning and audit risk assessment

### Questions:

4. What are the TWO component risks of the risk of material misstatement (RoMM) ?
  - a. Inherent risk
  - b. Detection risk
  - c. Control risk
  - d. Audit risk



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## Recap on audit planning and audit risk assessment

### Questions:

5. Which of the following definitions best describes detection risk?
  - a. Risk that entity's controls do not prevent or detect material misstatements
  - b. Risk that financial statements are materially misstated prior to audit
  - c. Risk that audit procedures performed do not detect a material misstatement
  - d. Risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated



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## Recap on audit planning and audit risk assessment

### Questions:

6. Are the following statements true or false?

#### Statement 1

A company that is based in a highly competitive industry where products have to be developed and launched quickly in order to keep up will be more exposed to control risk

#### Statement 2

A company which has suffered from the loss of several senior members of the finance team will be more exposed to control risk



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## Recap on audit planning and audit risk assessment

### Questions:

7. Are the following statements true or false?

#### Statement 1

Control environment sets the tone of an organisation influencing the control awareness of its people

#### Statement 2

Control activities are the processes to assess the effectiveness of internal control performance over time



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## Recap on audit planning and audit risk assessment

### Questions:

8. Which TWO of the following statements in relation to significant risk is true?
- a. Significant risks often relate to judgmental matters
  - b. Significant risks require special audit consideration
  - c. Significant risk has a lower level of inherent risk
  - d. Significant risks are assessed after the consideration of mitigating controls



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## Recap on audit planning and audit risk assessment

### Questions:

9. Are the following statements true or false?

#### Statement 1

Application of professional judgment is crucial when determining materiality

#### Statement 2

Overall materiality (i.e. materiality for the financial statements as a whole) is always calculated by applying a chosen percentage to a benchmark e.g., profit before tax



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## Recap on audit planning and audit risk assessment

### Questions:

10. Which of the following is UNLIKELY to be considered a material misstatement by an auditor?
- a. A misstatement that overstates profit by 10%
  - b. Non- disclosure of a related party transaction
  - c. A misstatement that understates profit by 0.005%
  - d. A HK\$1,500 misstatement that turns a profit into a loss



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## Recap on audit planning and audit risk assessment

### Questions:

11. Are the following statements true or false?

#### Statement 1

False / incorrect transactions and manipulation of accounting policies are examples of misappropriation of assets

#### Statement 2

Theft of inventory is an example of manipulation of financial statements



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# Recap on audit planning and audit risk assessment

## Questions:

12. Which of the followings are presumed significant risks under HKSA 240?
- a. Management override of controls
  - b. Fair value measurements
  - c. Revenue recognition
  - d. Related party transactions



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## PART 2

# Response to assessed risks



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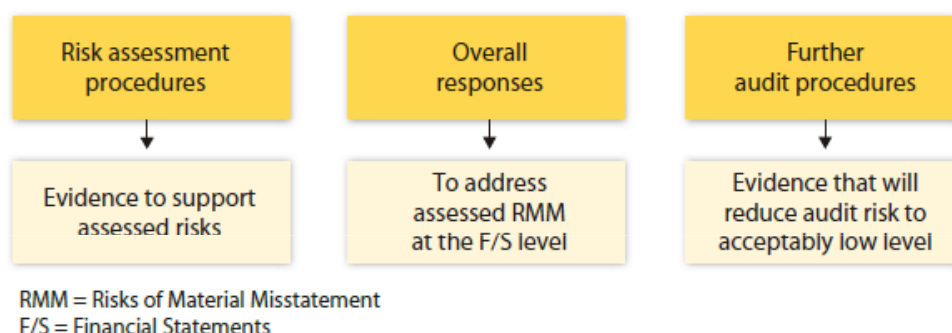
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# Response to assessed risks

## Overview

The three main categories of audit procedures are illustrated below.



The design of further audit procedures will be affected by:

- Results of performing risk assessment procedures and the resulting risk assessment at the assertion level; and
- Overall responses developed in relation to the assessed risks of material misstatement at the financial statement level



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# Response to assessed risks

## What are the auditing standards that are related to responding to assessed risks?

HKSA	HKSA objectives
330.3	The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, <u>through designing and implementing appropriate responses to those risks</u>
300.9	The auditor shall <u>develop an audit plan</u> that shall include a description of: (a) The <u>nature, timing and extent</u> of planned risk assessment procedures, as determined under HKSA 315.4 (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under HKSA 330.5 (c) Other planned audit procedures that are required to be carried out so that the engagement complies with HKSAs
500.6	The auditor shall <u>design and perform audit procedures</u> that are appropriate in the circumstances for the purpose of obtaining <u>sufficient appropriate audit evidence</u>

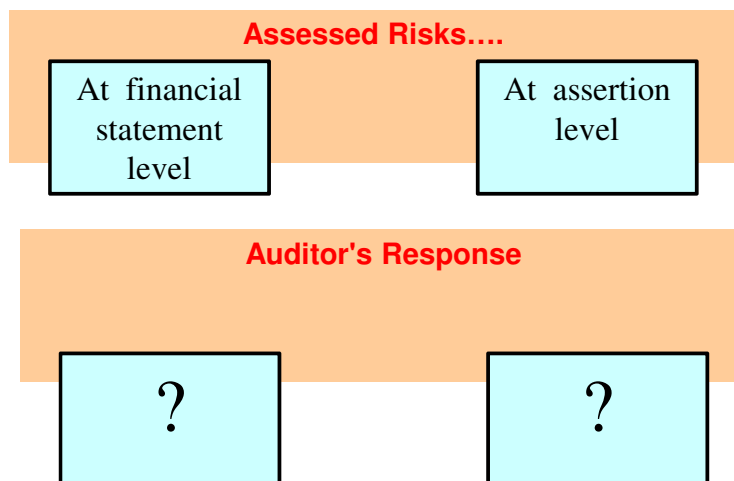


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## Response to assessed risks



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## Response to risk of material misstatement of financial statement as a whole



**What are risk of material misstatement of financial statement as a whole ?**

**Why do auditors need to respond to risks at the financial statement level ?**

**How do auditors need to respond to risks at the financial statement level ?**



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## Response to risk of material misstatement of financial statement as a whole



### What are risk of material misstatement of financial statement as a whole ?

The risk of material misstatement at the financial statement level refers to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions

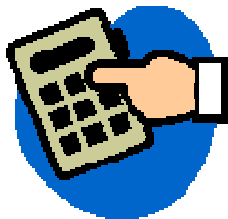


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## Response to risk of material misstatement of financial statement as a whole



### Why do auditors need to respond to risks at the financial statement level?

Risk that relate pervasively to the financial statements as a whole and potentially affect many assertions can contribute indirectly to material misstatements at the assertion level



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## Response to risk of material misstatement of financial statement as a whole



### How should auditors respond to risks at the financial statement level ?

The auditors should respond to the financial statement level risks by taking an **'overall response'**



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## Response to risk of material misstatement of financial statement as a whole

Refer to Annex 1 for some possible overall responses to risks identified at the financial statement level

- emphasizing to the audit team the need to maintain **professional scepticism**



- **assigning more experienced staff**, those with special skills or experts if the risks are greater



- incorporating **elements of unpredictability** in the selection of further audit procedures to be performed



- providing more supervision

- making general changes to the **nature, timing and extent** of audit procedures



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## Response to risk of material misstatement of financial statement as a whole

### Overall responses to risks at the financial statement level

What should we consider when determining the overall responses to risks at the financial statement level?

- Understanding of internal controls component, in particular, control environment

How will you decide the **overall responses** for an entity of effective control environment vs ineffective control environment?



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## Response to assessed risks

Risk Assessment	Possible Overall Response
An Effective Control Environment	<p>This allows the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity.</p> <p>An overall response could include some audit procedures being performed at an interim date rather than at the period end.</p>
An Ineffective Control Environment (Deficiencies Exist)	<p>This will likely require the auditor to perform some additional work such as:</p> <ul style="list-style-type: none"> <li>• Assigning more experienced audit staff.</li> <li>• Conducting more audit procedures at the period end rather than at an interim date.</li> <li>• Obtaining more extensive audit evidence from substantive procedures.</li> <li>• Making changes to the nature, timing, or extent of audit procedures to be performed.</li> </ul>



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## Overall responses to risks at the financial statement level

### Reminders:

- ✓ • The overall responses will have a bearing on the auditor's general approach and the types of further procedures that will also be used
- ✓ • Overall responses can be developed at the planning stage and then incorporated into the overall audit strategy
- ✓ • In new engagements, the overall responses can be developed on a preliminary basis during planning, and later confirmed or changed based on the results of the risk assessment
- ✓ • Establishing the overall audit response and audit strategy in a small entity need not be a complex or time-consuming exercise. In some cases, both steps could be completed by preparing a brief memorandum at the completion of the previous audit (assuming it covers all the required matters), which can be updated later based on discussions with management



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## Response to assessed risk at assertion level



The auditor's goal is to design procedures that match the assessed amount of risk

HKSA 330 requires the auditor to 'design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level

Because assessed risks differ between classes of transactions, account balances and disclosures, the most effective audit response will vary



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## Response to assessed risk at assertion level

### Nature

#### ▪ Purpose and type

### Timing

#### ▪ When is it performed

### Extent

#### ▪ Quantity to be performed

### Factors to consider when designing further audit procedures

- Nature of the assertion being addressed
- Reasons for the assessed risk
- Assessed level of risk
- Sources of information used
- Timing of procedures
- Materiality



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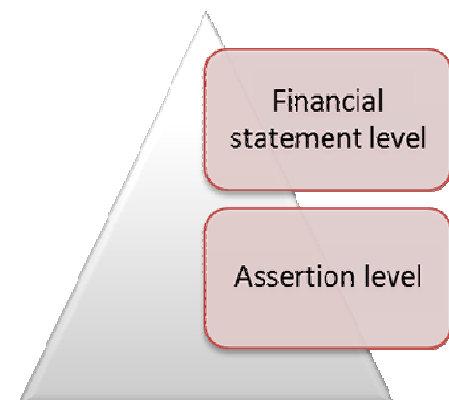
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## Scenario:

ABC Ltd is a garment manufacturer with major overseas customers residing in the US. Its annual turnover exceeds US\$500M.

You are the auditor of ABC. In March 2013, you have substantially completed your audit work of the financial statements for the year ended 31 December 2012 and are satisfied that there are no material misstatements. You intend to conclude the audit by 15 April 2013. On 2 April 2013, the Wall Street Journal has reported on the serious financial difficulty of ABC's largest customer, Y Limited. According to the report, the customer may declare bankruptcy.



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## Scenario:

What is your revised assessment of the risk of material misstatement of ABC Ltd's financial statement as a whole?

ABC Ltd's auditor should consider the below in assessing the risk of material misstatement relating to ABC Ltd's financial statements as a whole in response to the **rumour**:

- whether the valuation of the **accounts receivable** due from Y Limited will be **impaired** since Y Limited is reported in serious financial difficulty; and
- assess whether Y Limited is the single largest customer of ABC Ltd and whether the loss of business from Y Limited would seriously impact the **going concern** of ABC Limited



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## Scenario:

What are the further audit procedures you would design to complete your audit and to give audit opinion on ABC's financial statements for the year ended 31 December 2012?

ABC Ltd's auditor should consider the below audit procedures in response to the rumour:

- Discuss with management about the rumour and management's assessment of the rumour
- Perform independent check on Y Limited's financial stability
- Review year end outstanding accounts receivable balance due from Y Limited and assess any potential recoverability issue since Y Limited was reported that it is in serious financial difficulty
- Understand and evaluate management's business and settlement plan with Y Limited, if any
- Review ABC Ltd's current financial position, budget and projected cash flow forecast and assess whether ABC Ltd is able to continue the operation as a going concern even if Y Limited is proven to be in financial difficulty
- Reassess whether management has adopted an appropriate financial statements basis of preparation and consider whether sufficient financial statements disclosure has been made on going concern



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# PART 3

## Further audit procedures in general



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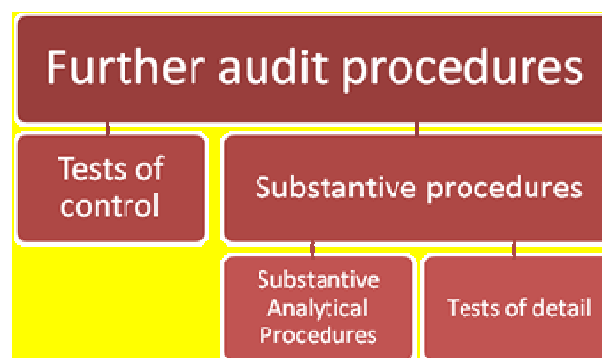
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## Further audit procedures in general

When determining a response at the assertion level, the auditor will use **professional judgment** to select the appropriate mix of audit procedures available. HKSA 330 differentiates between three key types of procedures as shown

- **tests of controls (TOC)**
- substantive procedures - **tests of detail (TOD)**
- substantive procedures – **substantive analytical procedures (SAP)**



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## Further audit procedures in general

### Test of controls

#### What are tests of control ?

Tests to evaluate and gather evidence as to the **operational effectiveness** of relevant internal controls that:

- address specific assertions where reliance on controls is planned; and
- prevent or detect/correct material errors or fraud from occurring

Confirming **controls were applied** at relevant times and consistently during the period

#### Examples

- **Observe** the operation of an internal control procedure being performed e.g., observe a bank reconciliation being performed
- **Inspect** evidence that the control procedures was performed e.g., inspecting an invoice to see if there is evidence of approval for payment
- **Re-perform** the operation of the control procedure (such as where the information system is computerised)
- **Inquire** about how and when the procedures was performed



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Inquiry alone is not a sufficient audit evidence

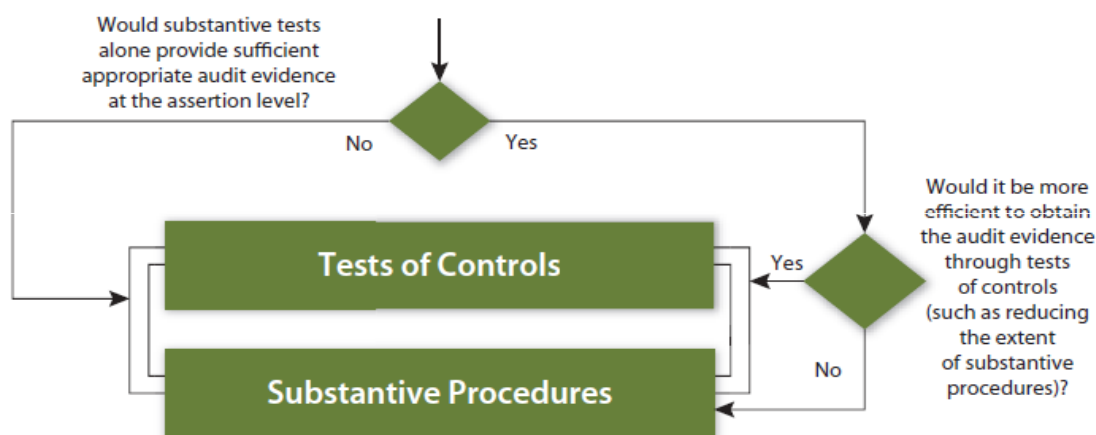
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## Further audit procedures in general

### Test of controls

#### When would tests of control be used?



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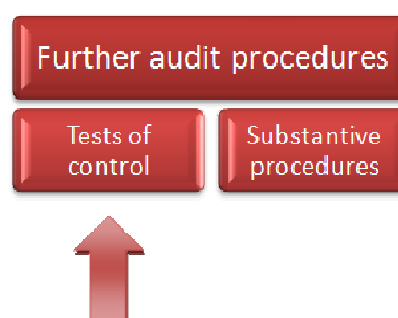
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# Further audit procedures in general

## Test of controls

### Reliance on operating effectiveness of controls

- Based on the assessment of risks, if the auditor believes control risk to be low (controls are operating effectively), it may be more efficient to perform tests of control to see if controls are operating effectively. If they are, this will allow a reduction in substantive procedures required
- If however the auditor believes control risks to be high, a substantive approach will be more appropriate



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# Further audit procedures in general

## Test of controls

### The testing approach of internal control

1. Risk and the related assertion to be addressed
2. Identify controls relevant to the audit
3. Evaluate the design
4. Review the implementation
5. Test of controls effectiveness
6. Documentation



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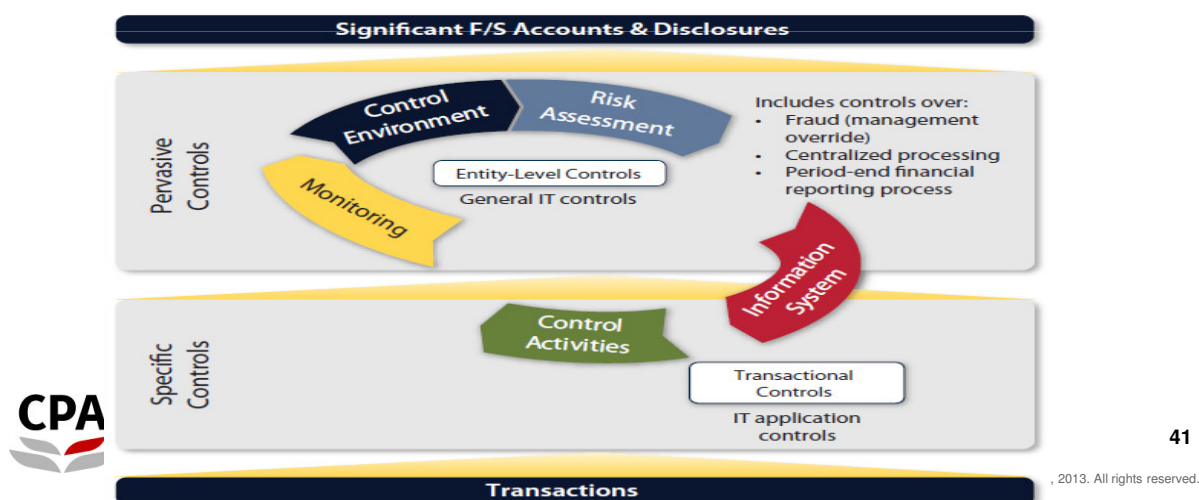
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## Further audit procedures in general

### Test of controls

#### Designing test of controls

- 1) Perform audit procedures in combination of inquiry to obtain audit evidence on:
  - **How the controls were applied** at relevant times during the period
  - The **consistency** with which they were applied
  - **By whom** or **by what means** they were applied
- 2) Remember to consider all the five elements of internal control components



## Further audit procedures in general

### Test of controls

#### Designing test of controls

- 3) Selecting the sample
  - Determine the evidence to be obtained in relation to the assertions
  - Select the **appropriate population**
    - Testing sales completeness VS testing sales occurrence
  - Determine the **sample size**
  - Determine the **basis of selection**

The following table is the guidelines provided in the Guide to Using International Standards on Auditing in the Audits of Small and Medium-Sized Entities issued by IFAC

Control Operates	Suggested Minimum Sample
Weekly	10
Monthly	2-4
Quarterly	2
Yearly	1

# Further audit procedures in general

## Test of controls

### Designing test of controls

#### 4) Determine what constitutes a control deviation

When designing a test of control, spend time to define exactly what constitutes an error or exception to the test. This will save time spent by audit staff in determining whether a seemingly minor exception (such as an incorrect telephone number) is, in fact, a control deviation



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# Further audit procedures in general

## Test of controls

### Timing of test of controls

Test of control may provide evidence of effective operation:

- **At a particular point in time** (.e.g. at physical inventory count); or
- **Over a period of time**, such as the period under audit

When tests of controls take place before the period end, the auditor would consider what additional evidence may be required to cover the remaining period. This evidence may be obtained by

- extending the tests to cover the remaining period, or
- testing the entity's monitoring of internal control



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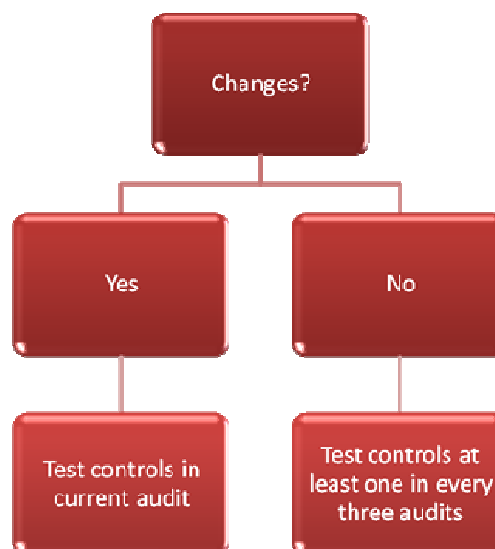
## Further audit procedures in general

### Test of controls

#### Rotational testing of controls

The diagram shows that

- if there have been **changes** then the current audit will need to include tests of controls
- If there have been **no changes**, tests of control will need to be done on rotation. However, **if this approach is adopted the auditor must still test some controls at each audit. This would need to be documented clearly**



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## Further audit procedures in general

### Test of controls

#### Rotational testing of controls

Reliance on control testing performed in prior years is **NOT** permitted when:

- **“significant risk”** is involved
- The operation of the internal control has **changed during the period**
- A **weak control environment** exists
- **Poor ongoing monitoring of internal control** operation
- **Significant manual element** to the operation of control
- **Personnel changes** that significantly affect the application of control
- **Weak or ineffective general IT control**



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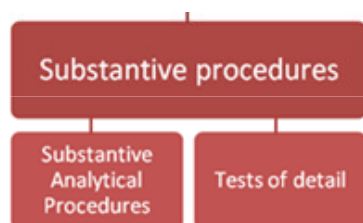
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# Further audit procedures in general

## Substantive Procedures

Substantive procedures are performed by the auditor to:

- **Gather evidence regarding the underlying assertions** that are embedded in the account balances and underlying classes of transactions;
- **Detect** material misstatements



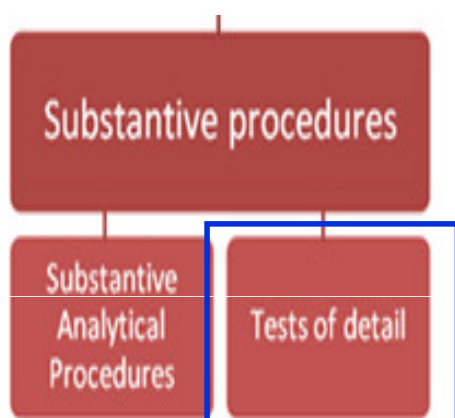
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# Further audit procedures in general

## Substantive test of details



### What are they?

Tests designed to detect material misstatements at the assertion level by gathering evidence that will substantiate the balances, classes of transactions or disclosures in the financial statements.

### Examples

- **Observe** physical existence of recorded assets such as inventory by attending inventory counts
- **Inspect** supporting documentation (such as invoices or sales contracts)
- Ensure transactions are recorded in the right period (**cut-off tests**)
- **Confirmation** (such as debtors' circularization, bank confirmations)



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## Further audit procedures in general

### Timing of test of details



If procedures are performed at an interim date, the remaining period must be addressed by performing:

1. further substantive procedures, combined with tests of controls for the intervening period; or
2. further substantive procedures only if the auditor determines that it is sufficient

that provide a reasonable basis for extending the audit conclusions from the interim date to the period end date

If unexpected misstatements are detected at an interim date, consider whether the followings need to be modified

- related risk assessment
- planned nature, timing or extent of substantive procedures covering the remaining period



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### Substantive test of details

#### Reminders:

- ✓ For each **material balance**, class of transactions, and disclosures. Test of details is **required** irrespective of the assessed risks of material misstatement
- ✓ Required audit procedures related to financial statement closing process including **examining material journal entries and other adjustments** made during the course of preparing the financial statements, **agreeing or reconciling the financial statements to the underlying accounting records**
- ✓ Design and perform substantive procedures that are responsive to the identified risks
- ✓ When the approach to **a significant risk consists only of substantive procedures**, those procedures shall include **tests of details**



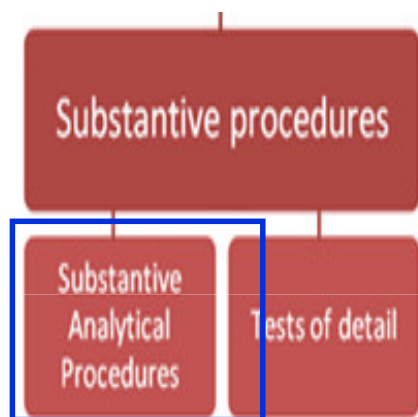
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# Further audit procedures in general

## Substantive analytical procedures



### What are they?

Tests designed to detect material misstatements at the assertion level by evaluating financial information through analysis of plausible relationships among both financial and non-financial data. It will often involve developing expectations for amounts in the financial statements, comparing with actual and then evaluating whether this identifies a potential misstatement

### Examples

- **Recalculate** recorded amounts to check accuracy such as depreciation expense
- Compare amounts between periods or with expectations (**analytical procedures**)



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# Further audit procedures in general

## When is substantive analytical procedures used?



It is often more useful when there are large volumes of transactions that tend to be predictable over time e.g., comparing payroll expense from previous year to current year budget to check accuracy and completeness.

**Substantive analytical procedures will be further discussed in the later session**



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## Further audit procedures in general

### Example

An auditor wishes to obtain sufficient appropriate evidence about the risk of material misstatement of insurance expenses within the income statement. The auditor would select appropriate procedures to gather evidence on the relevant assertions for classes of transactions (as expenses are classes of transactions within the income statement). What type of tests could be done within each category ?

### Test of control – accuracy, classification

Review invoices paid for evidence of approval and correct coding to the general ledger

### Tests of detail – accuracy, occurrence, cut off

- Check a sample of recorded insurance expenses against invoices
- Check a sample of insurance expense invoices around the period end and check recorded in correct period or recorded as accrual/prepayment appropriately

### Substantive analytical procedures – accuracy, completeness

Compare insurance expense to previous year. Predict current year expense in light of anticipated increase in premium and changes in policy profile. Compare prediction to actual and investigate significant differences



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## Further audit procedures in general

**Can we perform substantive audit procedures prior to year end date?**



Audit procedures can be performed before or after the period end, depending on the type of procedure. There can be advantages in performing audit procedures early (known as the interim audit) such as:

- significant matters are identified early;
- it helps manage internal resources;
- it reduces the burden on the entity's time at the period end



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## Further audit procedures in general

What are the factors to decide whether to perform audit procedures prior to the period end?



Factors to be considered for hard close:

- how good are controls and the control environment?
- will the required evidence be available early?
- what is the assessed risk of material misstatement?
- would performing the procedure early give evidence over the assertion?
- how much more work will be required for the period from the test date to the period end?



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## Further audit procedures in general

### Reminders:

✓ **The choice of the right procedures and right mix to obtain sufficient appropriate evidence on material financial statement areas will depend on a number of different factors/considerations**

- Avoid defaulting to generic or standard audit procedures where possible
- Multiple assertions
- Low-risk areas
- Consider using tests of controls
- Do not ignore IT controls
- Dual-purpose tests
- Consider work performed on all parts of a transaction stream
- Consider the use of analytical procedures
- Decide on audit strategy and procedures at the planni



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## Further audit procedures in general

### Reminders:

#### Responding to significant risks

	Audit steps	Description
✓	Evaluate internal control design & implementation over each significant risk	<ul style="list-style-type: none"><li>Consider the existence of direct and indirect (pervasive) controls</li><li>Evaluate management's awareness of the risks and the appropriateness of responses for those significant non-routine matters</li><li>If management has not appropriately responded by implementing internal control over significant risk, a significant deficiency in internal control would exist, which would be communicated to TCWG</li></ul>
✓	Design audit response	<ul style="list-style-type: none"><li>Consider if the planned audit procedures specifically address the significant risk</li><li>Consider if there are any specific requirements under other HKSAs to address particular significant risks</li></ul>



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## Further audit procedures in general

### Reminders:

#### Responding to significant risks

	Audit steps	Description
✓	No reliance can be placed on evidence obtained in previous periods	Where a test of internal control is planned for a control that mitigates a significant risk, the auditor cannot rely on audit evidence about the operating effectiveness of internal control obtained in prior periods
✓	Substantive analytical procedures (SAP) alone are not sufficient	<p>The use of SAP alone is not considered an appropriate response to address a significant risk. When the approach to significant risks consists only of substantive procedures, the audit procedures shall consist of either:</p> <ul style="list-style-type: none"><li>test of details alone; or</li><li>a combination of test of details and SAP</li></ul>



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## Documentation - Further audit procedures

### ✓ Reminders:

The auditor will need to document the following:

- the nature, timing and extent of further procedures
- linkage of the procedures with assessed risks at the assertion level
- justification for using audit evidence obtained in prior periods
- the results of the audit procedures including conclusions
- subsequent changes for the overall strategy and audit plan and the reasons for such changes
- evidence of review prior to the completion of the audit



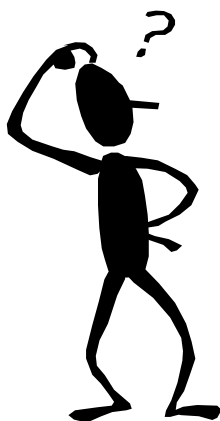
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## Further audit procedures in general

Before you sign off on your audit plan, ask yourself "Is your audit plan complete .... "



Consider the following questions:

- ✓ Have **all material financial statements** items been addressed?
- ✓ Is there a **need for external confirmation**?
- ✓ Can evidence obtained in **prior periods be used**?
- ✓ Is there a need for an **auditor's expert**?
- ✓ Has the financial statement **closing process** been addressed?
- ✓ Have **significant risks** been addressed?
- ✓ Has evidence obtained from **interim testing been updated**?
- ✓ Have the **potential fraud risks** been addressed?
- ✓ Have the assessed risks on financial statement **presentation and disclosures** been addressed?



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## For your reference



Refer to Annex 2 for a list of substantive tests to address different financial statement assertions

Refer to Annex 3 for an example on the documentation of risk assessment and audit approach summary in Practice Note 26 (Revised) issued by the Auditing Practice Board



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## PART 4

# Analytical procedures



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# Analytical Procedures

1. What are analytical procedures (AP)?
2. Preliminary AP
3. Substantive AP
4. Final AP
5. Overall recap



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# Analytical Procedures

## What are analytical procedures?

- Analytical procedures can be defined as the audit procedure which **analyze** and **compare related figures, trends and ratios**
- The **data** may be **financial or non-financial and may originate from inside or outside the client's organisation**
- Analytical procedures include the **investigation of identified fluctuations or relationships** that are inconsistent with other relevant information or from expected values by a significant amount
- The purpose of analytical procedures is **to scrutinize the financial position and the results of a business** to discover items which warrant further investigation, including anything unusual or expected and also anticipated fluctuations which do not appear



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# Analytical Procedures

## What are analytical procedures?

- **HKSA 315** *Identifying and assessing the risks of material misstatement* requires the auditor to perform analytical procedures as part of the risk assessment procedures
- **HKSA 520** *Analytical procedures* requires the auditor to obtain relevant and reliable evidence when using substantive analytical procedures and to design analytical procedures near the end of the audit to assist in forming an overall conclusion



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# Analytical Procedures

## What are analytical procedures?

Analytical procedures are used for three primary purposes:

### Preliminary analytical procedures

- To obtain an understanding of the business and its environment to help assess the risk of material misstatement in order to determine the nature, extent and timing of audit procedures.

### Substantive analytical procedures

- To obtain evidence to detect material misstatement at the assertion level when more efficient than performing tests of detail.

### Final analytical procedures

- To review the financial statements at the end of the audit to assess whether they are consistent with the auditor's understanding of the entity.

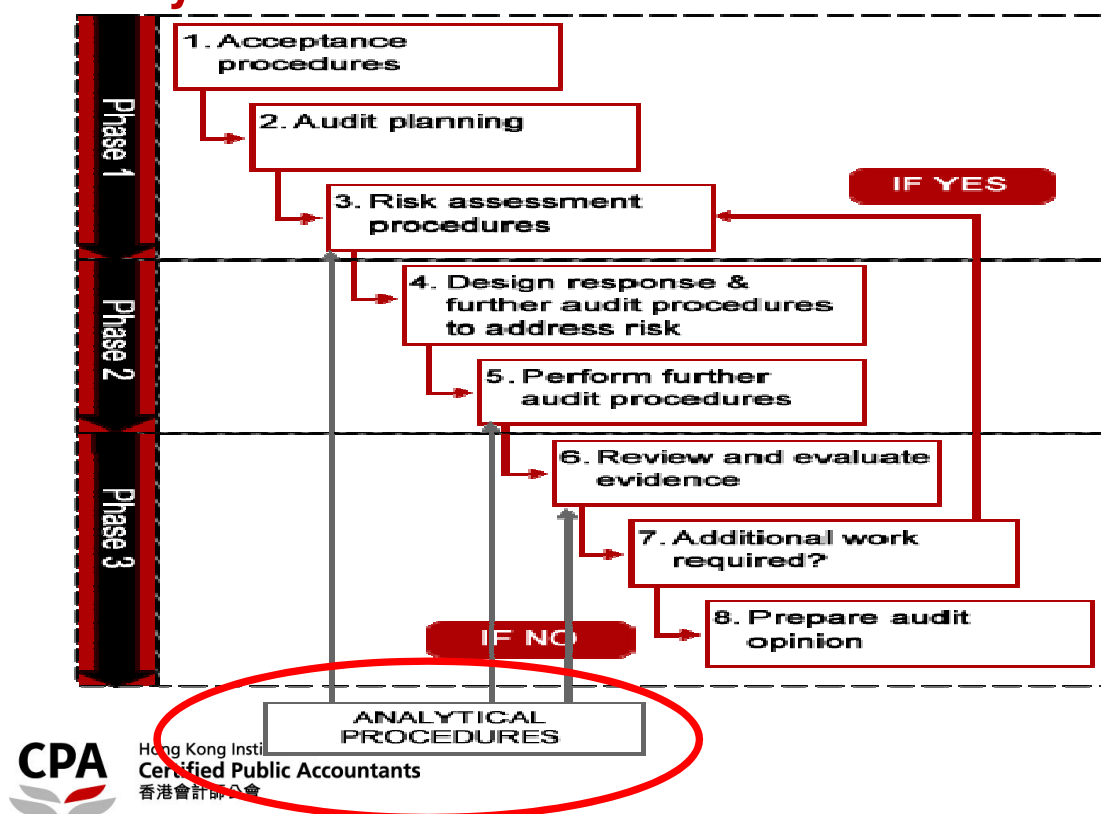


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## Analytical Procedures



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## Analytical Procedures

- Analytical procedures are part of the process of obtaining audit evidence
- Analytical procedures are an important technique performed at various stages of the audit

Stage	Known as	Optional?	HKSA
Planning	Preliminary AP	<b>Must be performed</b>	HKSA 315
Review and evaluation	Final AP		HKSA 520
Performance of substantive procedures	Substantive AP	<b>May be performed</b>	HKSA 520

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# Analytical Procedures

## Examples of analytical procedures

- Various methods can be used to perform analytical procedures ranging from performing **simple comparisons** to **complex analyses** using advanced statistical techniques. An auditor will need to use **professional judgment** when deciding what methods to use
- Examples include:
  - ❖ **Comparisons of the entity's financial information with:**
    - comparable information for prior periods
    - anticipated results e.g., budgets/forecasts
    - expectations of auditor e.g., an estimate of depreciation
    - similar industry information e.g., comparison of sales/accounts receivable with industry averages or comparable entity



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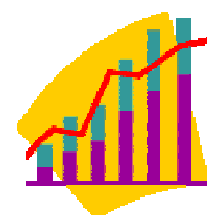
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# Analytical Procedures

## Examples of analytical procedures (Con't)

- ❖ **Consideration of relationships:**
  - among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience e.g., gross margin percentage
  - between financial information and relevant non financial information e.g., payroll costs to number of employees
- Techniques:
  - Ratio analysis
  - Trend analysis
  - Reasonableness test
  - Regression analysis



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# Analytical Procedures

## Preliminary analytical procedures

- **HKSA 315** requires the use of analytical procedures as a risk assessment procedure as it can help the auditor identify aspects of the entity which the auditor was unaware of and may assist in assessing the risk of material misstatement
- Preliminary analytical procedures may help **identify the existence of unusual transactions / events, or unusual amounts, ratios and trends** that may indicate matters that have audit implications
- Preliminary analytical procedures may have to be performed on aggregated data at a high level and so the results can only give a **very broad initial indication** about whether a material misstatement may exist. **To get a proper understanding of the risks, this information must be considered alongside other information obtained during risk assessment to understand and evaluate the results fully**



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# Analytical Procedures

## Preliminary analytical procedures (Con't)

### Information sources suitable for analytical procedures at risk assessment stage

- Budgets/forecasts
- Management accounts
- Interim financial accounts
- Board minutes
- Bank and cash records
- Cash flow forecasts
- Discussions or correspondence



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# Analytical Procedures

## Scenario example

### Extract from income statement of Company X

	20X1 CU'000 (estimate)	20X0 CU'000	% change
Revenue	2,818,958	1,710,610	+65
Cost of sales	2,227,016	1,363,860	+63
Gross profit	591,942	346,750	+70
Salaries & wages	255,571	334,195	-24
Admin costs	19,778	17,890	+11
Audit fee	9,720	9,630	+1
Bank charges	115	59	+95
Other finance costs	58	63	+8
Advertising	497	833	-40



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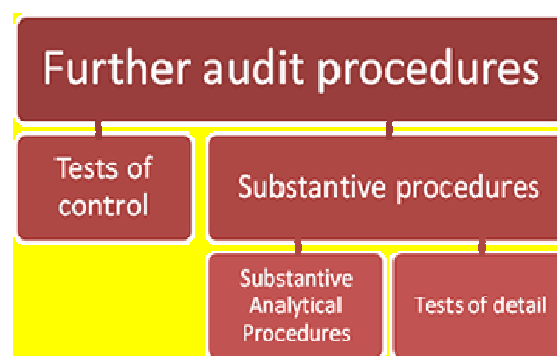
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# Analytical Procedures

## Substantive analytical procedures (substantive AP)

- Remember auditor's substantive procedures at the assertion level can be **tests of detail, substantive analytical procedures or a combination of both**. The auditor has to determine the mix based on the assessed risk



- If the assessed risk is low.....
- If the auditor is addressing significant risk.....



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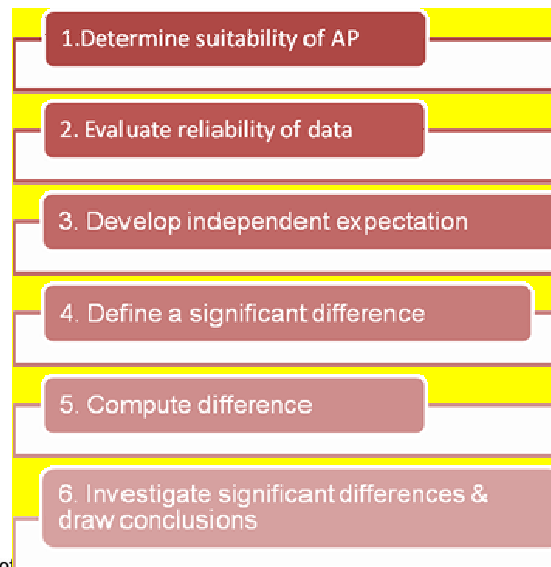
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# Analytical Procedures

## Process for performing substantive AP

- The process for performing substantive AP is shown in the diagram and explained further



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# Analytical Procedures

## Suitability (step 1)

- An auditor must consider the suitability of particular substantive analytical procedures for given assertions. AP can be a suitable substantive procedure in the following instances:
  - for **large volumes of transactions** that tend to be more predictable over time
  - when there is an **expectation that relationships amongst data exist** and continue in the absence of known conditions to the contrary
  - **when use of the AP is so persuasive** it eliminates the need for further verification through tests of detail
  - **to identify issues** that may not be apparent from more detailed work and direct the auditor's attention to areas requiring further investigation
  - if **data being used to perform AP is reliable** (taking into account source, comparability, nature and relevance of information available and controls over preparation)



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# Analytical Procedures

## Reliability (step 2)

- Consider **four key factors in relation to the information available**:

Factor	Example
<b>Source</b>	Information may be <b>more reliable if obtained from independent sources outside the entity</b>
<b>Comparability</b>	<b>Broad industry data</b> may need to be supplemented to be comparable to that of an entity that produces and sells specialised products.
<b>Nature and relevance</b>	Whether budgets have been established as <b>results to be expected rather than goals to be achieved</b>
<b>Controls over preparation</b>	Controls over the preparation of the information used, designed to <b>ensure its completeness, accuracy and validity</b>

**How do we ensure the data used in forming the expectation is reliable?**

# Analytical Procedures

## Develop independent expectation (step 3)

- an **appropriately precise, objective expectation**.
- is a prediction of a recorded amount or ratio. The prediction can be a specific number, a percentage, a direction or an approximation, depending on the desired precision
- develop by **identifying plausible relationships** (e.g., between store square footage and retail sales, market trends and client revenues) that are reasonably expected to exist based on knowledge of the business, industry, trends, or other accounts
- Easier to develop if:
  - it is related to recurring item (vs one-off item)
  - there is disaggregated information
  - there is reliable financial and non-financial information

# Analytical Procedures

## Define a significant difference (step 4)

- **HKSA 520** requires the auditor to determine the amount of difference from the expectation that can be accepted without further investigation. **The maximum acceptable difference is commonly called the 'threshold'**
- Thresholds may be defined either as numerical values or as percentages of the items being tested. **To prevent bias in judgment, the auditor should determine the threshold while planning the substantive analytical procedures**
- The maximum acceptable difference will be influenced by:
  - materiality
  - required level of assurance
  - assessment of risk (i.e., if risk is high, the amount of acceptable difference without investigation will reduce)



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# Analytical Procedures

## Compute difference (step 5)

- The auditor must compare the expected value with the recorded amounts and then identify significant differences, if any. This should be simply a mechanical calculation. **It is important to note that the computation of differences should be done after the consideration of an expectation and threshold to avoid the computation influencing the expectation.**



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# Analytical Procedures

## Investigate significant differences and draw conclusions (step 6)

### Questions:

1. What should be the proper / acceptable difference between the recorded amount and the expected amount where investigation is not needed?
2. What investigation procedures should the auditor perform?
3. What can be your conclusions?



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# Analytical Procedures

## Investigate significant differences and draw conclusions (step 6)

1. When differences arise, the auditor would consider the level of assurance that the procedures are intended to provide and the auditor's performance materiality. The amount of acceptance difference without investigation would, in any event, need to be less than performance materiality.

2. Procedures include:

- ✓ Reconsider the methods and factors used in forming expectations
- ✓ Enquire management the causes of differences and assess responses
- ✓ Perform other audit procedures to corroborate management's explanations

The auditor will need to seek explanations for the full amount of the difference, not just the part that exceeds the threshold. There is a chance that the unexplained differences may indicate an increased risk of material misstatement.



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# Analytical Procedures

## Example

Aim of test : Evidence over accuracy of overdraft interest expense	
<b>Determine suitability</b>	Suitable due to relationship between overdraft balance and interest rate
<b>Reliability</b>	Overdraft balance and rates of interest can be obtained from independent sources
<b>Develop independent expectation</b>	Average overdraft balance x average overdraft interest rate
<b>Define a significant difference</b>	This is subjective but is usually based on risk and materiality e.g. 15% of overall materiality
<b>Compute difference and investigate if significant</b>	Actual overdraft interest expense less predicted overdraft interest expense



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## What are the problems?

### Reasonableness test on interest expenses

	Bank loans		
	XXX 1	YYY 2	ZZZ 3
Opening balance	5,000,000	-	
Closing balance	4,750,000	10,000,000	
Average balance	4,875,000	5,000,000	
Interest rate	LIBOR + 0.8%	fixed rate at 3%	
Actual Interest rate	1.05%	3%	
No. of days outstanding	365	365	
Expected interest	51,188	150,000	
Actual Interest rate	50,300	75,000	
Variance	888	75,000	

Note (i)

Note (i)

The loan was drawn down in late September and no repayment was made during the year.



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# Analytical Procedures

## Final analytical procedures

- The auditor has to design and perform analytical procedures near the end of the audit that assist the auditor to form an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.
- The results of these final analytical procedures may therefore allow the auditor to address the following questions:
  - Do the conclusions drawn from such procedures corroborate the conclusions formed during the audit of individual components or elements of the financial statements?
  - Is there a risk of material misstatement that has not been previously recognised?



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# Analytical Procedures

## Some reminders



- It is important to remember that **analytical review provides good quality evidence** in the sense that it is evidence that the auditors have themselves constructed
- It can **provide audit evidence with relatively little effort**, but that requires an understanding of the business and some initial judgment as to what one would expect the position to be
- In performing analytical review, the auditors should bear in mind that **figures and ratios used must be computed on a consistent basis**, are not distorted by price level changes or exceptional items
- After calculating the figures and ratios and making appropriate comparisons, the auditors should **compare the results with their expectations** based on their knowledge of the business, budgets, etc.



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# Analytical Procedures

## Some reminders (cont'd)

- Unexpected results must be investigated and verified before they can be accepted
- All material variations should be discussed with client and explanations obtained
- Remember to set sufficient evidence of expectations and thresholds for investigation by the auditor
- Pay attention to consideration about the reliability of evidence obtained from management and the corroboration of that evidence
- **Analytical review procedures are a powerful audit tool if used with thought and at the right time**



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## PART 5

# Audit sampling



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# Audit sampling

## Overview



In order to get the level of detection risk right, the auditor must carefully consider the extent of audit procedures (“testing”) to be performed.



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# Audit sampling

## Means of selecting items for testing

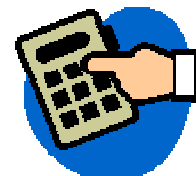
When designing tests of control and tests of detail, the auditor has to determine how many items to test and how to select the items in order to meet the purpose of the audit procedure being performed.

The following are some methods of selecting items for testing:

- select all items to test;
- select specific items to test; or
- use audit sampling.

### Question:

In what circumstances will you use the above methods in selecting items for testing? Why?



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# Audit sampling



## Means of selecting items for testing

### A. Selecting all items (100%)

The auditor examines the entire population\* of items that make up a class of transaction or account balance.

This would generally not be used for tests of controls but may be applicable to tests of detail when:

- the population comprises **a small number of large value items**;
- there is a **significant risk** and other means don't provide sufficient appropriate evidence;
- the population has a **repetitive nature or involves automated processing** and so all items can be tested **using computer assisted audit techniques** which may be more cost effective.

\*A Population is the entire set of data from which a sample is selected and about which an auditor wishes to draw a conclusion.



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# Audit sampling



## Means of selecting items for testing

### B. Select specific items

The auditor selects specific items from a population based on the auditor's understanding of the entity, the assessed RoMM and the population's characteristics.

This method may be suitable for:

- **high value or key items** (suspicious, unusual, risk prone)
- **all items over a certain value**
- Any **unusual or sensitive items**
- Any items that are **highly susceptible to misstatements**;
- items that provide information about the entity e.g., nature of entity, nature of transactions;
- items to test the operation of certain control activities e.g., testing items in one month.

**NOTE: This method DOES NOT provide evidence in relation to the remainder of the population.**



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# Audit sampling

## Means of selecting items for testing

### C. Audit sampling

The auditor uses a technique to select less than 100% of items to test but in such a way that a conclusion can be drawn about the entire population from testing the selected sample. This is because the sample selected is representative of the entire population.

Using audit sampling to reduce detection risk (and therefore audit risk) has a number of advantages. The auditor:

- can draw valid conclusions on the entire population as the sample is representative of it;
- can keep costs down as 100% examination can be very time consuming.



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## Audit sampling

### Statistical sampling

An approach to sampling that involves:

- random selection of sample items;
- the use of probability theory to evaluate sample results including measurement of sampling risk.

Statistical conclusions about the population can be reached if statistical sampling is used.

### Non-statistical sampling

A sampling approach that doesn't have the characteristics of statistical sampling.

Conclusions are reached about the population using professional judgement.

It can be used in combination with other audit procedures that address the same assertion.



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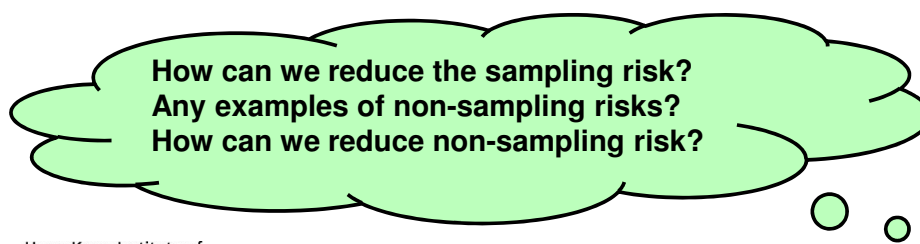
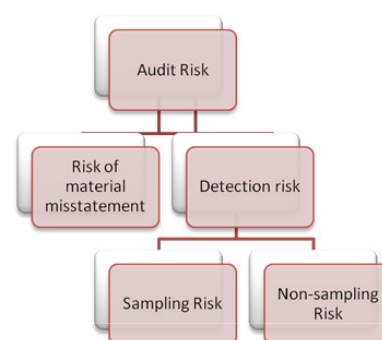
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# Audit sampling

## Sampling risk

<b>Sampling risk</b>	The risk that the auditor's conclusion, based on a sample, may be different from the conclusion if the entire population were subjected to the same audit procedure.
<b>Non sampling risk</b>	The risks that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. This can be reduced by proper planning, supervision and review.



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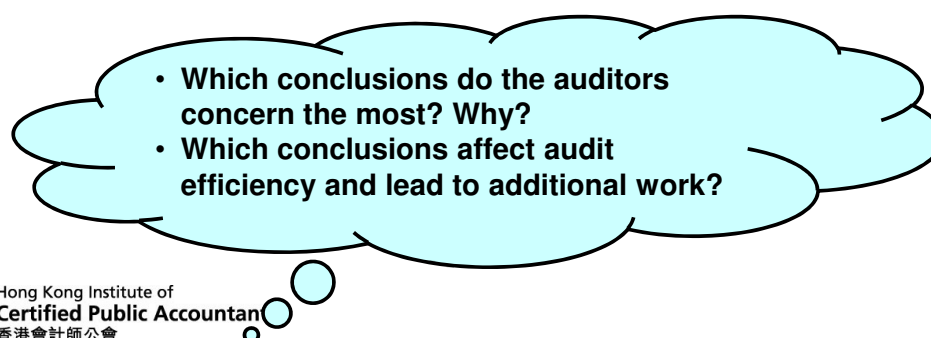
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# Audit sampling

## Sampling risk (cont'd)

Sampling risk can lead to two types of erroneous conclusions:

<b>Test of controls</b>	1) Controls are more effective than they actually are
	2) Controls are less effective than they actually are
<b>Test of details</b>	1) Material misstatement does not exist when in fact it does
	2) Material misstatement exists when in fact it does not



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# Audit sampling

## Tolerable misstatements or rate of deviation

In order for the auditor to determine the appropriate sample size in relation to the level of sampling risk, the auditor will need to determine how much misstatement or deviation from controls the auditor can tolerate. This will involve determining either:

- a **tolerable level of misstatement** (for substantive procedures) e.g., HK\$100,000 in relation to receivables; or
- a **tolerable rate of deviation** (for tests of control) e.g., 2% of controls tested

### Tolerable misstatement – substantive procedures

Tolerable misstatement will be set in relation to **performance materiality** and will often be **the same (or lower)**. It is the total of aggregate misstatements that could go undetected without the auditor's opinion changing in relation to the RoMM.

### Tolerable rate of deviation – tests of controls

This is **the rate of deviation** from the prescribed internal control procedures that the auditor **could accept without changing opinion** on the operating effectiveness of the controls.



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# Audit sampling

## The Process

### 1. Design sample

The auditor would consider:

- purpose of test & combination of procedures to achieve this purpose;
- nature of evidence sought;
- potential misstatement or deviation conditions;
- what is a misstatement or deviation;
- what population to use;
- characteristics of population and expected level of deviation or misstatement;
- whether to stratify population for tests of detail e.g., by value so that can direct greater audit effort to larger value items; or by age so can direct greater audit effort e.g., on allowances against receivables to those that have been outstanding for longer;
- whether to use monetary unit sampling for tests of detail where the probability of an item being selected for testing is in proportion to the monetary value of the item.



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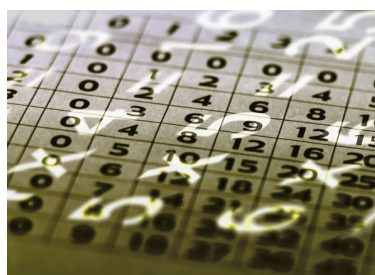
# Audit sampling

## The Process

### 2. Determine size

The auditor would determine the level of sampling risk the auditor is willing to accept so that the sample size can be determined. Various factors influence the sample size e.g.,

- the risk the auditor is willing to accept
- the tolerable rate of deviation and tolerable misstatement
- the expected rate of deviation / tolerable misstatement



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# Audit sampling

## The Process

### 2. Determine size

**What is the effect on the sample size for tests of details?**

- a) An increase in the auditor's assessment of the risk of material misstatement

Increase

Decrease

No Change

- b) An increase in the use of other substantive procedures directed at the same assertion

Increase

Decrease

No Change



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# Audit sampling

## The Process

### 2. Determine size

#### What is the effect on the sample size for tests of details? (cont'd)

c) An increase in tolerable misstatement

Increase

Decrease

No Change

d) An increase in the amount of misstatement the auditor expected to find in the population

Increase

Decrease

No Change



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# Audit sampling

## The Process

### 2. Determine size

#### What is the effect on the sample size for tests of details? (cont'd)

e) An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement

Increase

Decrease

No Change

f) An increase in the number of sampling units in the population

Increase

Decrease

No Change



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# Audit sampling

## The Process

### 3. Select items for testing

If using statistical sampling, the auditor selects items so that **every sampling unit has an equal chance of being selected**. If using non-statistical sampling, the auditor uses judgement to select sample items but it should still be representative of the population and so bias must be avoided.

Methods	Descriptions
Random	Apply through random number tables or generators
Systematic	Divide number of sampling units in population by sample size (to derive n) and having determined a starting point select every nth sampling unit after that.
Monetary unit sampling (Value-weighted)	For tests of detail, selection ensures that every HK\$1 in the population has an equal chance of being selected.
Sequence or block selection	Selection of a block(s) of items from within the population



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# Audit sampling

## The Process

### 4. Perform audit procedures

What would you do with the samples in the following circumstances?

- While testing for payment authorisation, a voided cheque is selected.
- While testing for sales transaction for occurrence, the client cannot provide relevant supporting (e.g. delivery note and settlement details) for a particular sample.
- One of the debtor confirmation has not been received.



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# Audit sampling

## The Process

### 5. Investigate and project

#### Investigation

Investigate the nature and cause of any deviations in control or misstatements identified and evaluate the impact on the audit procedures or on other areas of the audit.

- Identify **one off**, referred to as an '**anomaly**' or an '**anomalous error**'

This is an error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore **not representative of errors in the population**. If this is the case, the auditor will need to obtain a high degree of certainty that such misstatement or deviation in control is not representative of the population



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# Audit sampling

## The Process

### 5. Investigate and project (cont'd)

- Project misstatements

#### Tests of detail – projection of misstatements

The auditor will **project misstatements** found in the sample to the population to get a broad view of the scale of misstatement. Where a misstatement has been established as an anomaly, it may be excluded when projecting misstatements to the population.

Projected + anomalous misstatements > or ~ tolerable misstatements  
→ actual misstatements has or may exceed tolerable misstatements

#### Tests of control – projection of control deviations

**No explicit projection of deviations** is necessary since the sample deviation rate is also the projected deviation rate for the population as a whole.



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# Audit sampling

## The Process

### 6. Evaluate results

Evaluate:

- the results of the sample;
  - a. In tests of control, an unexpectedly high sample deviation rate may lead to an increased in assessed RoMM.
  - b. In tests of detail, an unexpected high misstatement amount in a sample may cause the auditor to believe that a class of transactions or account balances is materially misstated in the absence of further audit evidence.
- whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested.



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## PART 6

# External confirmations



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## External confirmations

External confirmations are a useful technique to obtain evidence about account balances (typically assets) and their components. They can also be a useful technique for confirming:

- terms of agreements;
- transactions an entity has with third parties;
- absence of certain conditions e.g., side agreements.

Generally external confirmations received directly by the auditor from confirming parties will often be more reliable than evidence generated internally by the entity. For this reason HKSA 330 requires that the auditor must, as a minimum, consider whether external confirmation procedures should be performed rather than ruling it out without consideration.

Don't assume external confirmations are **ALWAYS** reliable. If the confirming party is not knowledgeable then the reliability of the external confirmation will be undermined!



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## External confirmations

### Where could external confirmations be used practically?

They are often used to provide audit evidence about the following assertions:

- completeness of a liability;
- existence of an asset;
- accuracy of recorded amount;

HKSA 505 *External confirmations* requires that if auditors are using external confirmations, they should be designed such that 'relevant and reliable' evidence is obtained.



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## External confirmations

### Where could external confirmations be used practically? (cont'd)

Examples of areas where external confirmations are used:

- Bank balances and other information relevant to banking relationships
- Accounts receivable balances and terms
- Inventories held by third parties for processing and /or on consignment
- Property title deeds held by lawyers or financiers for safe custody or as security
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the year-end date
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants
- Accounts payable balances and terms



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## External confirmations

### Where could external confirmations be used practically? (cont'd)

Factors to consider:

Address	Description
Dual Purpose Tests	Is there an opportunity to obtain audit evidence about other important matters at the same time (such as terms of a contract, etc.)?
Confirming Party's Knowledge of the Subject Matter	Responses will be more reliable if provided by a person knowledgeable in the subject matter.
Ability/Willingness of Confirming Party to Respond	Consider the reliability of the evidence obtained if there is possibility of the confirming party: <ul style="list-style-type: none"><li>• Not accepting responsibility;</li><li>• Viewing a response as too costly or time-consuming;</li><li>• Having concerns about potential legal liability;</li><li>• Accounting for transactions in different currencies; or</li><li>• Not treating the confirmation requests as significant.</li></ul>
Objectivity of the Confirming Party	Consider the reliability of the evidence obtained if the confirming party is a related-party. In such situations, consider: <ul style="list-style-type: none"><li>• Confirming additional details about the subject matter, such as terms of sales agreements, including dates, any rights of return, and delivery terms; and</li><li>• Supplementing the confirmation with inquiries of non-financial personnel regarding the subject matter, such as changes in sales agreements and delivery terms.</li></ul>

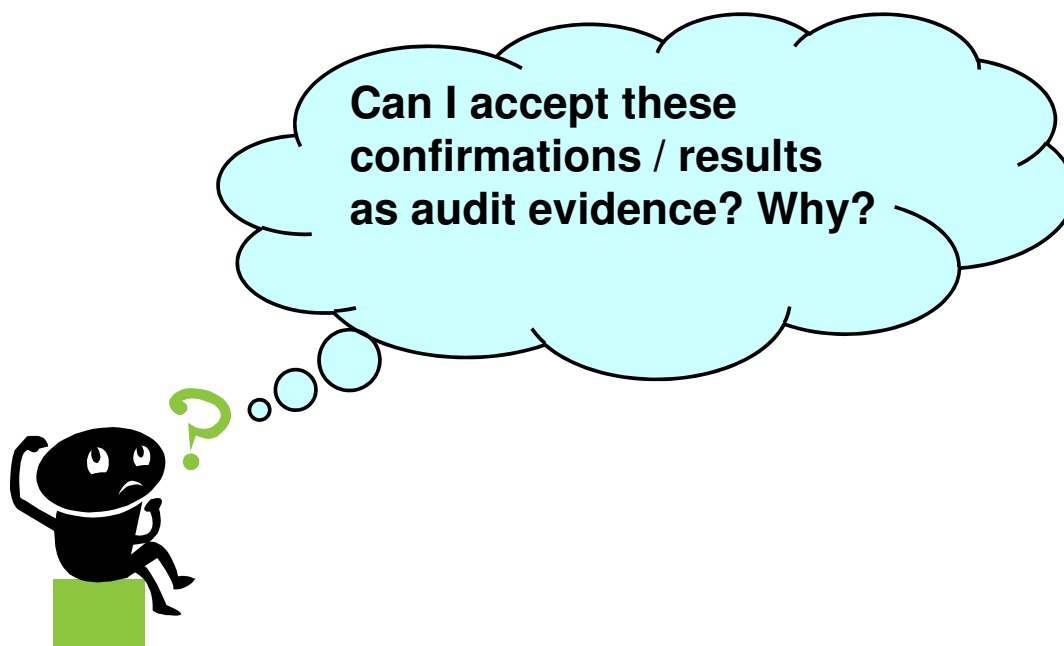


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## External confirmations



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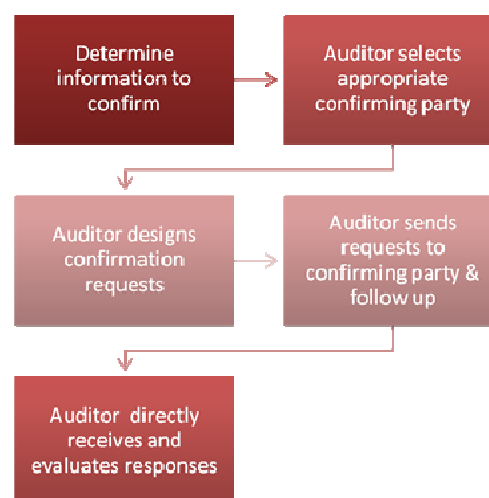
## External confirmations

### External confirmation procedures

When an auditor obtains evidence using external confirmations, they must maintain control over the process as shown opposite.

When designing the confirmation request, it is interesting to note that the design can directly impact how relevant and reliable the evidence obtained is. Design considerations may include:

- does it address the required assertions?
- is it laid out appropriately?
- is the method of communication suitable?
- has management authorised or encouraged the confirming parties to respond?
- is the confirmation requesting information that the confirming party can actually confirm?



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## External confirmations

### What type of requests can be sent?

There are two key types of confirmation requests, as detailed below:

- positive confirmations;
- negative confirmations.

#### Positive confirmation requests

A request that the confirming party respond directly to the auditor indicating:

- whether the confirming party agrees or disagrees with the information in the request; or
- providing the requested information e.g., the balance owed to the entity.

#### Negative confirmation requests

A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.



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## External confirmations

### What type of requests can be sent? (cont'd)

Negative confirmations provide less persuasive evidence than positive confirmations and so these should be used rarely as the sole substantive procedure to address an assessed RoMM at the assertion level unless **ALL** of the following are present:

- The auditor has assessed **the risk of material misstatement as low** and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion;
- The population of items subject to negative confirmation procedures comprises **a large number of small, homogeneous account balances, transactions or conditions**;
- A **very low exception rate** is expected; and
- The auditor **is not aware of circumstances or conditions** that would cause recipients of negative confirmation requests to **disregard such requests**.



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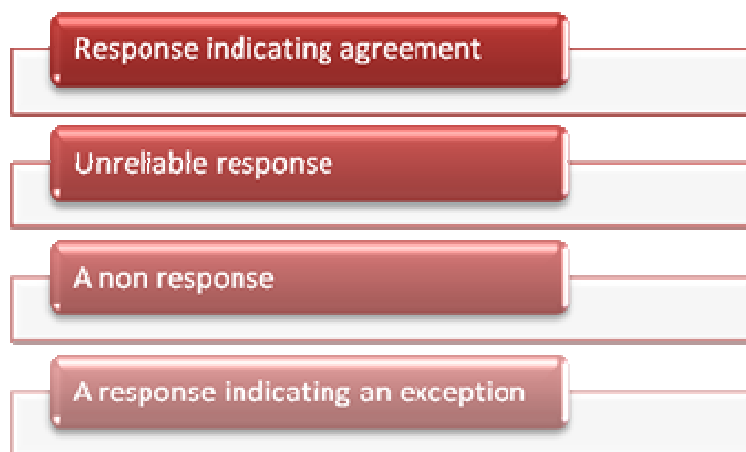
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## External confirmations

### Evaluating the evidence obtained

The auditor may categorise the results of confirmations in the categories shown below when evaluating external confirmations.



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## External confirmations

### Evaluating the evidence obtained (cont'd)

#### (i) Reliability

The auditor has to consider the reliability of confirmation request responses and if there is any doubt, the auditor has to obtain further audit evidence to resolve those doubts. Examples of reliability doubts might be:

- if the auditor **didn't receive the confirmation directly**;
- if the response **doesn't appear** to have come from the **originally intended confirming party**;
- if the response is received **electronically through an unsecure network**;
- if the confirmation response is made **orally**.



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## External confirmations

Can the auditor accept confirmations via fax or email?



HKSA 505.A12-A14

- Responses received electronically, for example, by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect.
- An electronic confirmation process might incorporate various techniques for validating the identity of a sender of information in electronic form, for example, through the use of encryption, electronic digital signatures, and procedures to verify web site authenticity
- The auditor may choose to verify the source and contents of a response to a confirmation request by contacting the confirming party. For example, when a confirming party responds by electronic mail, the auditor may telephone the confirming party to determine whether the confirming party did, in fact, send the response.



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## External confirmations

### The Parmalat scandal: Europe's ten-billion euro black hole

By Chris Sverige  
6 January 2004

The types of fraud allegedly carried out by Tanzi and his executive cohorts are myriad, with some bearing a similarity to those of Enron, while others are of a more rudimentary character. According to the charges, numerous shell companies were set up to generate fake profits for Parmalat and subsidiaries. In addition, Parmalat's finance director, Fausto Tonna, has told interrogators that he participated in a "cut and paste" forgery, in which a document with Bank of America letterhead was scanned and then added to a document verifying a deposit account with that bank holding over \$4.98 billion. The document was then passed through a fax machine several times in order to appear authentic.

Extracted from

<http://www.wsws.org/articles/2004/jan2004/parm-j06.shtml>



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## External confirmations

Remaining alert to the possibility of fraud in the confirmation process, especially confirmation is the primary audit evidence for a material items or if the item is susceptible to fraud

- Circumstances in which the confirmation process is conducted;
- Characteristics of the respondent, particularly its independence, objectivity, motivation and authority to respond; and
- The nature of the information received
- Unusual or unexpected responses, e.g. significant change in the number or timeliness of responses

Example:

Sending confirmation of the existence of investments held by an offshore entity



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Key consideration is whether the response has come from the purported sender. To verify:

- telephone the respondent / supervisor
- send confirmation at interim and final, and reconcile period movements
- Contact an audit or law firm in the offshore jurisdiction to confirm the existence of the investment

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## External confirmations

### Evaluating the evidence obtained (cont'd)

#### (ii) Non response

If there is no response even after follow-up, the auditor will have to perform alternative audit procedures to obtain relevant and reliable audit evidence.



#### Questions:

1. What are the alternative audit procedures?
2. When performing alternative audit procedures, can we do it on a "sample on sample" basis?



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## External confirmations

### Evaluating the evidence obtained (cont'd)

#### (iii) Responses indicating exception

If the confirming party reveals a discrepancy, the auditor will need to investigate the exception(s) to determine whether or not they are **indicative of misstatements** and whether there is **any indication of fraud**. Exceptions may also **indicate a deficiency or deficiencies in the entity's internal controls** over financial reporting.

However, exceptions will not always represent misstatements e.g., the auditor may conclude that differences in responses are due to timing, measurement or clerical errors in the external confirmation procedures



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## External confirmations

### Scenario example 1

James Co is being audited for the year ended 31 December 20X1. A confirmation of receivables has been performed by the auditor and responses are in the process of being reviewed by the auditor.

#### **Response from Customer J**

Customer J has responded that they owe James Co HK\$ 200,000 at 31 December 20X1, however James Co is showing a receivable of HK\$ 250,000 at the same date.

Further investigation reveals that Customer J had sent a cheque for HK\$ 50,000 on 28 December 20X1 which has not been received by James Co at the year end.

Is this a misstatement?



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## External confirmations

### Scenario example 2 (cont'd)

James Co is being audited for the year ended 31 December 20X1. A confirmation of receivables has been performed by the auditors and responses are in the process of being reviewed by the auditor.

#### Response from Customer K

Customer K has responded that they owe James Co HK\$450,000, but James Co is showing the receivable as HK\$ 475,000. Audit investigation reveals that James Co had dispatched HK\$25,000 of goods on 30 December 20X1 which have not been received as yet by Customer K.

Is this a misstatement?



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## External confirmations

### What if management refuse to allow the auditor to send a confirmation request?

HKSA 505 requires the auditor to:

- inquire as to why management are refusing and determine if the reason is valid;
- evaluate the implications on the assessed risk of material misstatement;
- perform alternative audit procedures to obtain relevant and reliable audit evidence.

If the auditor believes that management is being unreasonable and can't obtain sufficient appropriate evidence from alternative procedures, the auditor will need to communicate to TCWG and consider the implications for the audit opinion.



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## External confirmations

### Practical application – bank confirmations

#### Common questions:

1. Do we have to send bank confirmations for all bank balances as at the year end?
2. Where can we locate the latest bank confirmation templates?
3. What are the information confirmed by the bank confirmations?
4. What are the proper procedures for arranging bank confirmations?
5. How to handle the received bank confirmations?



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## External confirmations

### Practical application – bank confirmations

#### Common questions:

1. Do we have to send bank confirmations for all bank balances as at the year end?

HKSA 505 appendix 1

The auditor should send bank confirmation requests when the entity's banking activities, including treasury operations, are significant to the audit.

Through knowledge of the entity's business and audit planning, the auditor gains an understanding of the nature and extent of the entity's banking and treasury operations. Based on this understanding, the auditor would determine the significance of banking activities to the audit by reference to materiality and audit risk.



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## External confirmations

### Practical application – bank confirmations

#### Common questions:

2. Where can we locate the latest bank confirmation templates?

- English version in HKSA 505 appendix 2
- Chinese translation version

<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/auditing-assurance/example-reports/>



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## External confirmations

### Practical application – bank confirmations

#### Common questions:

3. What are the information confirmed by the bank confirmations?

The most commonly requested information includes:

- Current, deposit, loan and other accounts
- Accounts closed during the year
- Terms of arrangement, e.g. maturity and interest rate on loans, overdrafts, unused facilities, lines of credit/standby facilities, collateral given or received
- Contingent liabilities, such as guarantees
- Securities held by the bank

Annex 6 shows an example of bank confirmation extracted from Appendix 2 of HKSA 505.



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## External confirmations

### Practical application – bank confirmations

#### Common questions:

4. What are the proper procedures for arranging bank confirmations?
  - Determine the information to be confirmed and the samples selected, if any
  - Agree with the management on the scope
  - Ensure the relevant information has been filled **and signed by the authorised client** together with the company chop.
  - Collect the confirmation from the client and **send them to the bank directly**. To facilitate a reply, a pre-addressed envelope can be enclosed with the request.
  - Send the bank confirmation **in advance of the confirmed balance date**.



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## External confirmations

### Practical application – bank confirmations

#### Common questions:

5. How to handle the received bank confirmations?
  - Check if the bank has **answered all the questions** on the confirmation
  - Check if there are any **authorised signature and bank chop**
  - Assess if there are any doubts about the reliability of the responses
  - **Investigate exceptions** to see if there are any misstatements
  - **Tie the response** on the confirmation to the relevant audit file
  - For **non-responses**, proper follow up should be made. Perform **alternative procedures** for confirmations with no responses



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## External confirmations

### Other practice issues

#### Use of Technology

- some financial institutions will no longer accept and respond to paper confirmation received by mail and will only respond electronically through designated third party service providers
  - Web portals are used and grant the auditor a unique ID and password to access to client's account statements.
- Expose to same sort of risks as email / fax confirmations

If a respondent will only respond to a confirmation request through a third party service provider and the auditor plans to rely on the service provider's process, it may be important that the auditor be satisfied with the controls over the information sent by the entity to the service provider, and the controls applied during processing of the data and preparation and sending of the confirmation response to the auditor. **A service auditor's report on the service provider's process may assist the auditor in evaluating the design and operating effectiveness of the electronic and manual controls with respect to that process. Such a report will often address the three types of risk noted above.**



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## External confirmations

### Other practice issues

Refer the following link for details on other emerging practice issues regarding the use of external confirmations published by IAASB.

<http://www.ifac.org/sites/default/files/publications/files/emerging-practice-issues-re.pdf>



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# PART 7

## Related parties



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## Related parties

### Overview

- Risk exposure for related parties ("RP"):
  - Extensive and complex relationship structures
  - Transactions not carried out on the same terms as in an arm's length transaction
  - Completeness of RP relationship and the related transactions
- Applies HKSA 550 (Clarified) "Related parties"

### Auditor responsibilities

Applicable financial reporting framework establishes minimal requirements	Applicable financial reporting framework sets out specific requirements
Obtain understanding of RP transactions so the auditor: <ul style="list-style-type: none"><li>• can recognise <u>fraud risk factors</u> if any which may increase risk of material misstatement due to fraud</li><li>• can conclude whether the financial statements in respect of RP relationships and transactions are <u>fairly presented or not misleading</u>.</li></ul>	In addition to the steps on the left, obtain sufficient appropriate evidence to assess whether entity has complied with <u>specific requirement in financial reporting framework</u> .



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# What are the requirements of HKSA 550?

## Audit approach - overview

<b>Phase 1 Risk Identification and assessment</b>	<ol style="list-style-type: none"> <li>1. Identify RPs, including changes from previous periods.</li> <li>2. Understand the nature, extent and purpose of RP transactions.</li> <li>3. Consider the potential for fraud.</li> <li>4. Remain alert to identifying RP transactions throughout audit.</li> <li>5. Consider significant risks.</li> </ol>
<b>Phase 2 Responding to risk</b>	<ol style="list-style-type: none"> <li>1. Consider if auditor's working knowledge of the entity suggest involvement of RPs.</li> <li>2. Obtain evidence to support management's assertions about the nature, extent and purpose of transactions.</li> <li>3. If transactions are outside the normal course of business, consider their significance.</li> <li>4. Consider measurement and recognition of transactions and balances.</li> <li>5. Consider possible fraud.</li> </ol>
<b>Phase 3 Evaluation and reporting</b>	<ol style="list-style-type: none"> <li>1. Consider if sufficient appropriate evidence has been obtained.</li> <li>2. Consider if a material misstatement exists.</li> <li>3. Consider adequacy of financial statement disclosures.</li> <li>4. Obtain management representations.</li> <li>5. Consider the implications of any findings on the audit report.</li> </ol>



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# What are the requirements of HKSA 550?

## Risk identification and assessment

### 1. Understand RP relationships and transactions

- identity of RPs, the nature of relationships, types and purpose of transactions with RPs
- understand the entity's control to identify, account for and disclose RPs relationships and transactions
- understand the entity's authorisation/approval controls

### 2. Maintain professional skepticism

- remain alert to undisclosed RP relationships/transactions
- inspect relevant documents including bank and legal confirmations, minutes of shareholder meetings and other documents which auditors consider appropriate.

HKSA 550 emphasizes the requirement to obtain these understanding through inquiries of management and discussion among the engagement team.

HKSA 550 also requires to include in the audit file documentation of the names of identified RPs and the nature of the RP relationships.



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# What are the requirements of HKSA 550?

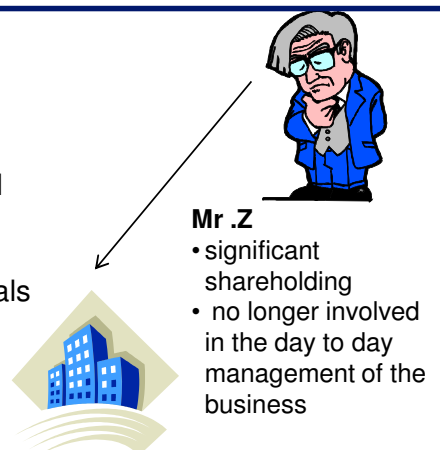
## Risk identification and assessment

### 3. Consider risk of material misstatements

- discuss susceptibility to fraud in relation to RP relationships and transactions
- identify fraud risk factors
- consider if any dominant influence has been exerted by a RP

Indicators of dominant influence:

- ✓ If Mr. Z vetoes significant business decisions taken by management
- ✓ If significant transactions are always referred to Mr. Z by management for final approval
- ✓ If there is little or no debate among management regarding business proposals initiated by Mr. Z
- ✓ If transactions involving Mr. Z are independently reviewed and approved



Mr. Z

- significant shareholding
- no longer involved in the day to day management of the business



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# What are the requirements of HKSA 550?

## Risk identification and assessment

### 3. Consider risk of material misstatements (cont'd)

- Identification of significant risks

HKSA 550 requires that the auditor should treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.

Examples include:

- complex equity transactions e.g. corporate restructurings or acquisitions;
- transactions with off-shore entities in jurisdictions with weak corporate laws;
- leasing of premises by entity to another party for no consideration;
- sales transactions with unusually large discounts or returns;
- transactions with circular arrangements e.g. sales with a commitment to repurchase.



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# What are the requirements of HKSA 550?

## Responding to risk

### 1. Previously unidentified/undisclosed RPs relationships or transactions

- Determine whether underlying circumstances in the entity confirm their existence.
- Promptly communicate the information to the engagement team.
- Request management to identify all transactions with the RPs.
- If the RP was not previously identified, investigate why, considering:
  - ✓ failure of any RP identification controls; and
  - ✓ fraud (non-disclosure by management appears intentional).
- Reconsider the risk that other undisclosed RP or significant RP transactions may exist, and perform additional audit procedures as necessary; and
- Perform appropriate substantive audit procedures



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# What are the requirements of HKSA 550?

## Responding to risk

### 2. Significant RP transactions outside normal course of business

- Inspect underlying contracts or agreements, if any, and evaluate whether:
- rationale suggests possible fraudulent financial reporting or concealment of misappropriated assets;
  - terms are consistent with management's explanations, and
  - transactions are accounted for and disclosed in accordance with the applicable financial reporting framework.
  - Ensure transactions have been appropriately authorized and approved.



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## What are the requirements of HKSA 550?

### Responding to risk

#### 3. Management asserts that RP transactions are carried at arm's length

- Obtain sufficient appropriate audit evidence about management's assertions about the nature and extent of RP transactions (e.g. compare terms of RP transaction to those of identical /similar transactions;
  - ✓ engage an expert to determine a market value;
  - ✓ compare terms to known market terms for broadly similar transactions).
- Consider whether external confirmation of the balances would provide reliable evidence.
- Consider the collectability and valuation of period-end balances.



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## What are the requirements of HKSA 550?

### Responding to risk

#### Obtain written representations

HKSA 550 requires the auditor to obtain written representations from management and those charged with governance ("TCWG") that:

- all identified related parties and transactions have been disclosed to the auditors; and
- such relationships and transactions have been appropriately accounted for and disclosed in the financial statements.

Auditor can also consider to obtain written representations regarding specific assertions that management have made.



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## What are the requirements of HKSA 550?

### Evaluation and reporting

Evaluate the followings:

- whether the identified RP relationships and transactions have been appropriately accounted for and disclosed
- whether the effects of the RP relationships and transactions:
  - ✓ prevents the financial statements from achieving fair presentation (for fair presentation frameworks).
  - ✓ causes the financial statements to be misleading (for compliance frameworks).

Reminder:

HKSA 450 *Evaluation of misstatements identified during the audit* requires the auditor to consider both the size and nature of a misstatement when deciding if a misstatement is material.

Lack of disclosures of a RP relationship or transaction can be a material misstatement irrespective of the value of RP transaction.



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## What are the requirements of HKSA 550?

### Evaluation and reporting

Reporting:

HKSA 550 requires that unless all TCWG are involved in management, the auditor should communicate to them significant matters during the audit in connection with the entity's RPs.

This could include:

- non-disclosure by management of RPs or significant RP transactions;
- significant RP transactions that have not been appropriately authorised and approved;
- disagreement between the auditor and management about the accounting for and disclosure of RP transactions.



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## PART 8

# Audit of accounting estimates, including fair value accounting estimates and disclosures



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## Accounting estimates

### Exercise

*Identify all the  
accounting estimates  
and fair value  
accounting estimates  
on the balance sheet.*

*What audit procedures  
will you perform in  
respect of these  
estimates?*



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# Accounting estimates

## Overview

- Applies HKSA 540 "Auditing, accounting estimates, including fair value accounting estimates, and related disclosures"
- Accounting estimates range from items such as the net realisable value of inventory and accounts receivable (relatively uncomplicated) to more complex items such as future liabilities on warranties or guarantees.

## Examples of areas where accounting estimates may be required:

- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Provision against carrying amount of investments
- Outcome of long term contracts
- Costs arising from litigation settlements and judgements
- Complex financial instruments which are not traded in an active market
- Share based payments



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# Accounting estimates



## Common issues:

- Insufficient audit evidence of challenge of the key assumptions and related disclosures (such as forecast revenues, discount rate etc.)
- Inadequate assessment of the sensitivity analysis or no such analysis performed when there were only slight margin over the carrying value
- Insufficient consideration to the appropriateness of the valuation methodologies applied, for example, the direction of the movements in value was explained in broad terms only
- Inappropriate identified cash generating units (CGUs) for goodwill impairment
- Improper determination of recoverable amounts under HKAS 36
- Inadequate disclosures in the financial statements



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# What are the requirements of HKSA 540?

## Audit approach - overview

<b>Phase 1 Risk Identification and assessment</b>	<ol style="list-style-type: none"> <li>1. What estimates are required?</li> <li>2. How were the estimates prepared?</li> <li>3. <b>How significant</b> are the estimates?</li> <li>4. Does the auditor need advice from <b>an expert</b> to help assess reasonableness?</li> <li>5. How accurate were the <b>prior year's estimates</b>?</li> <li>6. Is there any evidence of <b>management bias</b>?</li> <li>7. What is the <b>extent of estimation uncertainty</b> involved?</li> </ol>
<b>Phase 2 Responding to risk</b>	<ol style="list-style-type: none"> <li>1. Have estimates been properly prepared using consistent methodology?</li> <li>2. Is the supporting evidence <b>reliable</b>?</li> <li>3. Is there any evidence of <b>fraud</b>?</li> </ol>
<b>Phase 3 Evaluation and reporting</b>	<ol style="list-style-type: none"> <li>1. Are financial statement disclosures on accounting estimates in accordance with the financial reporting framework?</li> <li>2. If there is a significant risk of material misstatement, has disclosure been made of the estimation uncertainty?</li> <li>3. Have we got management representations?</li> </ol>

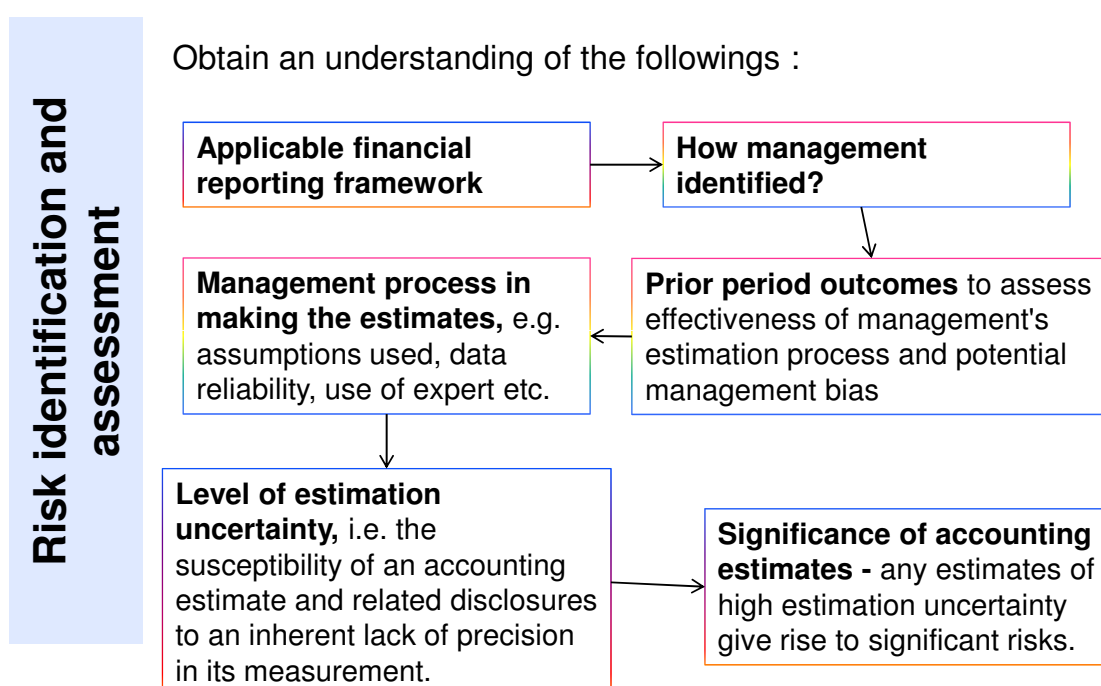


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# What are the requirements of HKSA 540?



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## What are the requirements of HKSA 540?

### Risk identification and assessment

How to consider the level of estimation uncertainty?

Consider an entity for which materiality is HK\$100,000:

A) The entity has an investment property, revalued each year to open market value. At the year end, the property is under offer for a price of HK\$20 million and conveyance is under progress smoothly.

High or low estimation uncertainty?

B) The same entity has a tax liability of HK\$50K, being tax on profits of HK\$1 M less group relief of HK\$950K. The group relief is under dispute and the tax advisors believe it could go either way.

High or low estimation uncertainty?



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## What are the requirements of HKSA 540?

### Risk identification and assessment

The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.
- The existence of recognized measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- The availability of reliable data from external sources.
- The extent to which the accounting estimate is based on observable or unobservable inputs.



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## What are the requirements of HKSA 540?

### Risk identification and assessment

#### Documentation

Please refer to Annex 7 for an example of documentation for accounting estimates.



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## What are the requirements of HKSA 540?

### Responding to risk

Auditors need to assess the followings:

- whether the requirements of the financial reporting framework has been appropriately applied
- whether methods used are appropriate and consistently applied
- whether any changes in estimates or methods from the prior period are appropriate in the circumstances  
e.g. does the change lead to inconsistent accounting, inappropriate smoothing of profit and is an indication of management bias?

**The use of professional judgement is crucial in these assessments.**



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## What are the requirements of HKSA 540?

### Responding to risk

HKSA 540 requires the auditor to respond in one or more of the following ways:

1. Consider if events after the year end date provide evidence regarding the accounting estimates
2. Test the method/model and the assumptions used by the management
3. Test the operating effectiveness of the internal controls over how management made the accounting estimate, together with appropriate substantive procedures
4. Develop a point estimate or a range to evaluate management's point estimate



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## What are the requirements of HKSA 540?

### Responding to risk

#### Further procedures for **significant risk**:

- Has management considered alternative assumptions or outcomes e.g. **using sensitivity analysis**.
- Whether any **significant assumptions** used are reasonable and whether there is support for them.
- How reasonable the assumptions are in terms of **management's ability and intentions** (as shown in plans and other documentation and history of carrying out intentions).

#### Obtain written representations:

- the reasonableness of any significant assumptions
- the completeness of disclosures, the appropriateness of the measurement process for estimates
- no subsequent event requires adjustment to the accounting estimates or their disclosure.



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## What are the requirements of HKSA 540?

### Evaluation and reporting

Evaluate whether:

- sufficient appropriate evidence has been obtained;
- the accounting estimates in the financial statements are reasonable or misstated;
- disclosures comply with the relevant financial reporting framework; and
- any accounting estimates which give rise to significant risk have been adequately disclosed.
- any management bias:
  - Changes in ways estimates are calculated.
  - Using management assumptions that are inconsistent with market assumptions.
  - Management estimates that indicate a pattern of optimism or pessimism



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## What are the requirements of HKSA 540?

### Evaluation and reporting

#### Reminders

Fair value measurement , e.g. properties, financial instruments

- Assess the model/method used and their underlying assumptions
- Consider use of auditor's experts
- Adequate disclosures

Refer to Annex 8 for example of documentation

#### Impairment of assets

- Recoverable amount – higher of value-in-use (VIU) and fair value less costs to sell under HKAS 36
- VIU – based on reasonable assumptions
  - Budget and forecast should not go beyond 5 years, unless justified
  - Further extrapolation using a steady or declining growth rate



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## What are the requirements of HKSA 540?

### Evaluation and reporting

#### Reminders (cont'd)

##### Impairment of assets (cont'd)

- VIU – Estimate future cash flows at its current condition
  - Exclude cash flows from financing activities and income tax
  - Exclude cash flows from uncommitted future restructuring and from improving or enhancing the asset's performance
  - Exclude financial assets such as receivable and recognised liabilities
- Discount rate: pre-tax and market – determined asset-specific
- CGU: lowest level and not be larger than an operating segment under HKFRS 8



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## What are the requirements of HKSA 540?

### Evaluation and reporting

#### Reminders (cont'd)

##### Impairment of assets – disclosures

- events and circumstances resulting in recognition/reversal of impairment losses
- assumptions and basis in determining the recoverable amounts
- explanation of substantial changes in key assumptions as compared to previous years
- sensitivity analysis of how possible changes in key assumptions would impact recoverable amounts
- CGU: description, amount impaired /reversed by class of assets and segment
- additional disclosures for CGU which contains goodwill or intangible assets with indefinite useful lives

This list is not exhaustive. Please refer to HKAS 36 Impairment of assets for details.



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# Thank you for your attention

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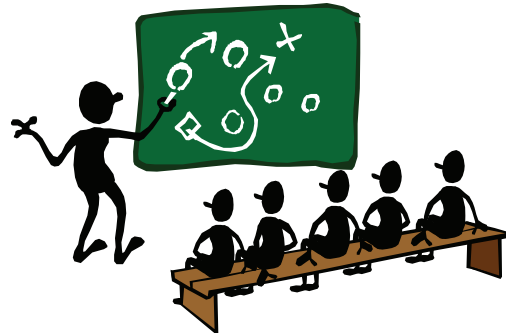
## **A Refresher Course on Current Auditing Standards**

### **Day 3**

<b>Time</b>	<b>Topic</b>
8:30 - 9:00	Registration
9:00 - 9:30	Recap on audit procedures
9:30 - 10:30	Subsequent events and going concern
10:30 - 10:45	Break
10:45 - 11:45	Use the work of an auditor's expert and / or internal auditors
11:45 - 13:00	Group audit
13:00 - 14:00	Lunch
14:00 - 15:00	Physical inventory count
15:00 - 15:45	Initial engagement and comparatives
15:45 - 16:00	Break
16:00 - 17:00	Audit documentation

Presented by : Winnie Chan, Associate Director, Technical Learning and Support, HKICPA  
Eky Liu, Manager, Technical Learning and Support, HKICPA  
Venue: The Hong Kong Institute of Certified Public Accountants

# ***A Refresher Course on Current Auditing Standards 2013 (Day 3)***



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## Agenda of today

- 1. Recap on audit procedures**
- 2. Subsequent events and going concern**
- 3. Use the work of an auditor's expert and/or internal auditors**
- 4. Group audits**
- 5. Physical inventory count**
- 6. Initial engagement and comparatives**
- 7. Audit documentation**



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# PART 1

## Recap on audit procedures



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## Recap on audit procedures

### Questions:

1. Are the following statements true or false?

#### Statement 1

The auditor must design responses, based on an assessment of the risk of material misstatement, to obtain sufficient appropriate evidence.

#### Statement 2

The auditor will design 'further audit procedures' as a response to financial statement level risks.



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## Recap on audit procedures

### Questions:

2. Which of these are examples of overall response to an assessment of risk?
  - a. Incorporating elements of unpredictability to timing of audit procedures
  - b. Assigning more experienced staff
  - c. Performing a walk through test
  - d. Engaging an expert



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## Recap on audit procedures

### Questions:

3. Which of the following are types of substantive procedure?
  - a. Tests of control
  - b. Tests of detail
  - c. Analytical procedures
  - d. Walk through tests



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## Recap on audit procedures

### Questions:

4. Are the following statements true or false?

#### Statement 1

If controls are extremely strong, the auditor need not perform any substantive procedures for the financial statements item as sufficient appropriate evidence can be obtained from the risk assessment procedures and tests of control.

#### Statement 2

The auditor must obtain external confirmations to address assertions associated with account balances.



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## Recap on audit procedures

### Questions:

5. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, which TWO of the following approaches would be suitable if the auditor ascertains that there have been no changes to those controls since the previous audit?

- a. Some controls must still be tested at each audit
- b. Tests of control can be performed in rotation
- c. All relevant controls must be tested during the current audit
- d. Controls do not need to be tested again until the controls are changed



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## Recap on audit procedures

### Questions:

6. At which TWO of the following stages MUST analytical procedures be performed?
- a. When performing substantive procedures
  - b. When evaluating control implementation
  - c. When performing risk assessment
  - d. When forming an overall conclusion



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## Recap on audit procedures

### Questions:

7. Are the following statements true or false?

#### Statement 1

At the planning stage analytical procedures are useful in identifying the existence of unusual transactions or events that may have audit implications.

#### Statement 2

Draft financial statements are required in order to perform analytical procedures at the planning stage.



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## Recap on audit procedures

### Questions:

8. Which of the following statements is FALSE?
- a. The auditor must determine the amount of difference from the expectation that can be accepted without further investigation
  - b. The higher the auditor's assessment of risk, the higher the amount of difference considered acceptable without investigation
  - c. The auditor's determination of the amount of difference from expectation that can be accepted without further investigation is influenced by materiality
  - d. The maximum acceptable difference may be defined as a numerical value or as a percentage



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## Recap on audit procedures

### Questions

9. Which of the following best describes 'audit sampling'?
- a. The auditor selects less than 100% of the population by selecting specific items over a certain value that make up a large proportion of the population's balance
  - b. The auditor selects the entire population of items to test
  - c. The auditor selects less than 100% of the population by selecting specific high value or risk prone items that could individually result in a material misstatement
  - d. The auditor selects less than 100% of items to test but in such a way that a conclusion can be drawn about the entire population



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## Recap on audit procedures

### Questions

10. Are the following statements true or false?

#### Statement 1

Tolerable rate of deviation will be a monetary amount set at lower or the same as performance materiality.

#### Statement 2

The lower the tolerable level of misstatement set the smaller the sample size.



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## Recap on audit procedures

### Questions

11. Are the following statements true or false?

#### Statement 1

If an accounting estimate poses a significant risk, the auditor should consider undertaking further audit procedures specified in HKSA 540.

#### Statement 2

Accounting estimates that have high levels of estimation uncertainty are likely to be significant risks



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## Recap on audit procedures

### Questions

12. Management have recorded an accounting estimate in the financial statements. Management regularly reviews and approves the estimate and reports the estimate to TCWG on a regular basis. The auditor has assessed the control environment at the entity to be strong.

Which approach would be the MOST appropriate when designing procedures to respond to the risk of material misstatement of this accounting estimate?

- a. Check against events up to the date of the auditor's report
- b. Test how management made the estimates
- c. Test operating effectiveness of controls over the accounting estimate
- d. Develop an estimate to compare with management's estimate



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## Recap on audit procedures

### Questions

13. Which ONE of the following risk assessment procedures is NOT mandated by HKSA 550 in relation to identifying and assessing risks of MM associated with related party relationships and transactions?

- a. Perform analytical procedures of related party transactions
- b. Obtain an understanding of the entity's related party relationships and transactions
- c. Share related party information with engagement team
- d. Maintain alertness for related party information when reviewing records or documents



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## Recap on audit procedures

### Questions

14. Which TWO of the following are more likely to be examples of related party transactions that give rise to a significant risk?
- a. Leasing of premises by entity to a related party for market rental
  - b. Transactions with circular arrangements e.g., sales with commitment to repurchase
  - c. Transactions with off-shore related parties in jurisdictions with weak corporate laws
  - d. Sales of goods to related parties at normal commercial terms



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## PART 2

### Subsequent Events

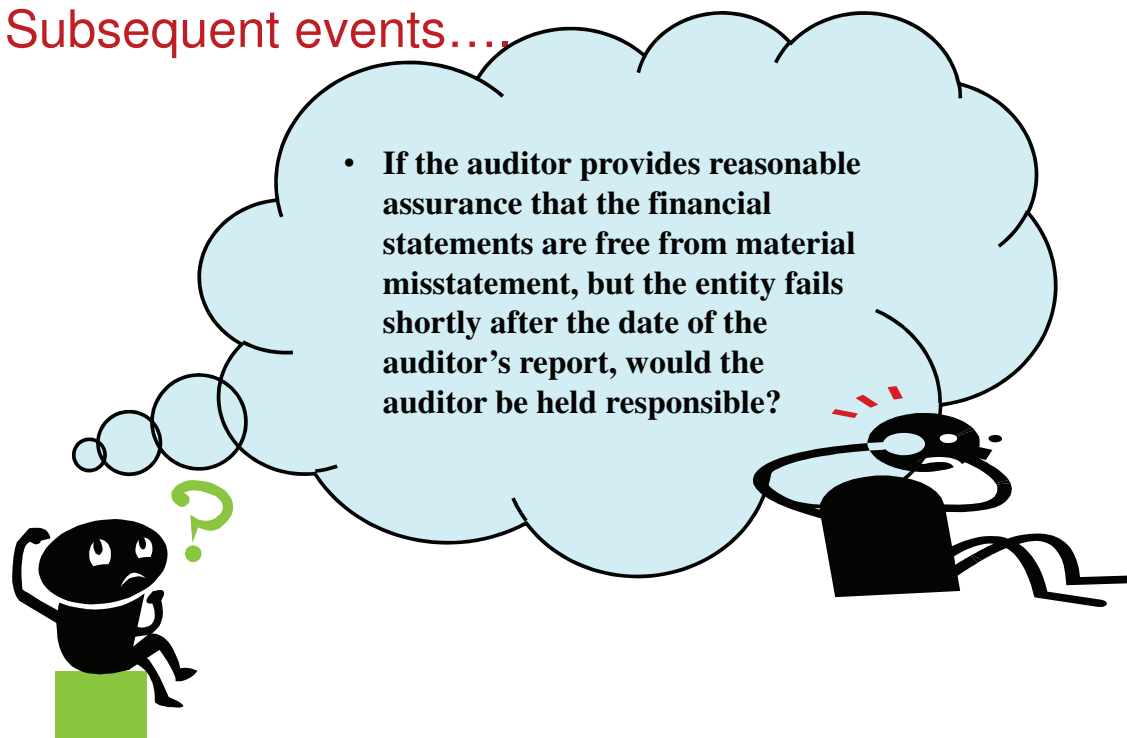


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## Subsequent events....



- If the auditor provides reasonable assurance that the financial statements are free from material misstatement, but the entity fails shortly after the date of the auditor's report, would the auditor be held responsible?



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## What are we going to learn?

- ✓ the auditor's responsibilities and obligations regarding subsequent events
- ✓ required actions to be taken by auditors if events occur after the financial statements date which require adjustment or disclosure in the financial statements
- ✓ required actions to be taken by the auditor if facts become known to the auditor after their report which would have impacted the audit opinion



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# Subsequent events

## Overview

- Financial statements may be affected by certain events that occur after the date of the financial statements (the period end date)
- If the auditor provides reasonable assurance that the financial statements are free from material misstatement, but the entity fails shortly after the date of the auditor's report, the auditor's **competence** and **quality** of opinion would be challenged

- Subsequent events are events occurring between the date of the financial statements and the date of the auditor's report and facts that become known to the auditor after the date of the auditor's report**
- HKSA 560 Subsequent Events** provides guidance to auditor's responsibility regarding subsequent events



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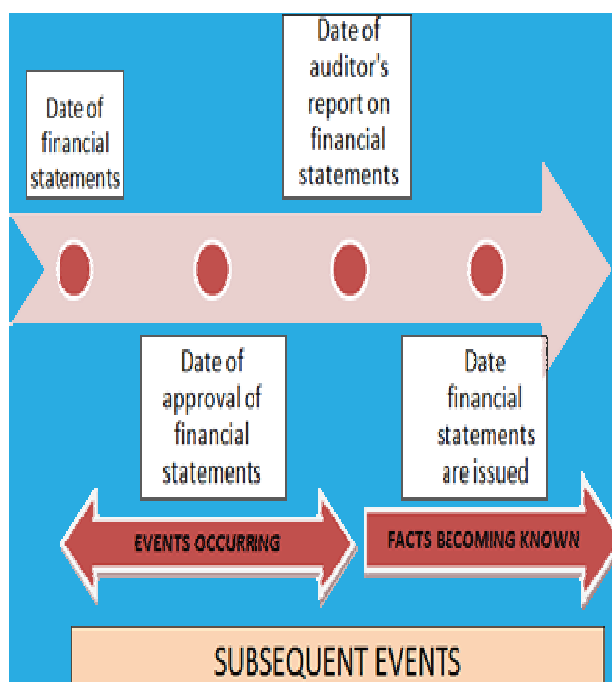
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# Subsequent events

## Key dates

- HKSA 560 Subsequent Events** also defines some **key dates** after the date of the financial statements

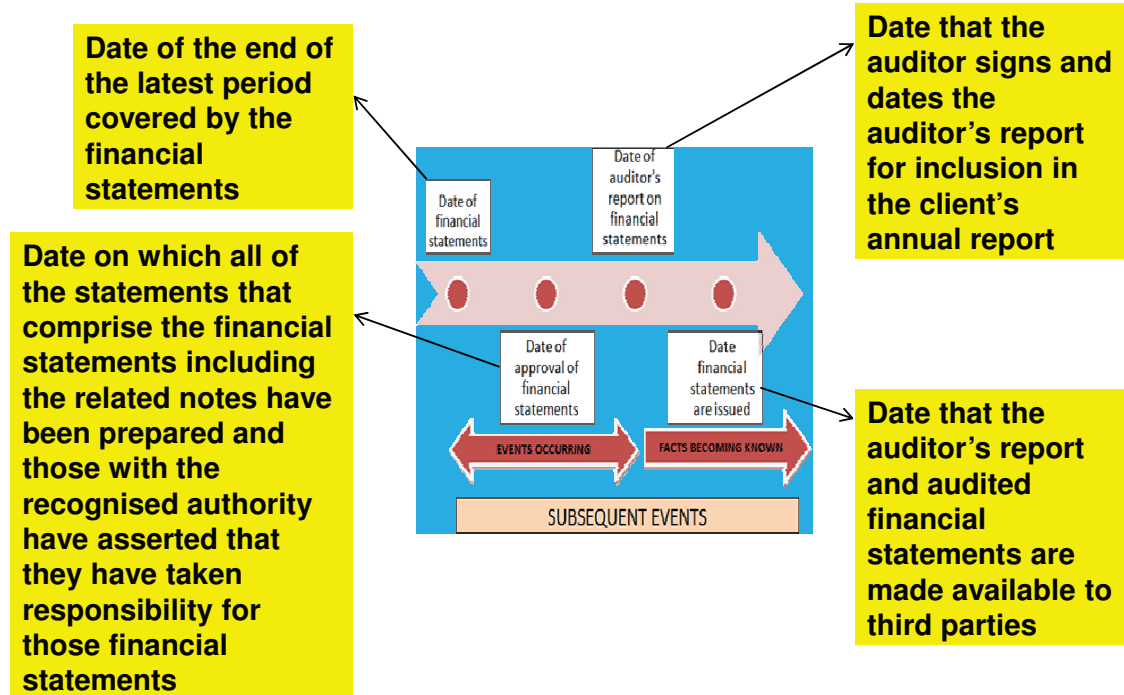


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## Subsequent events



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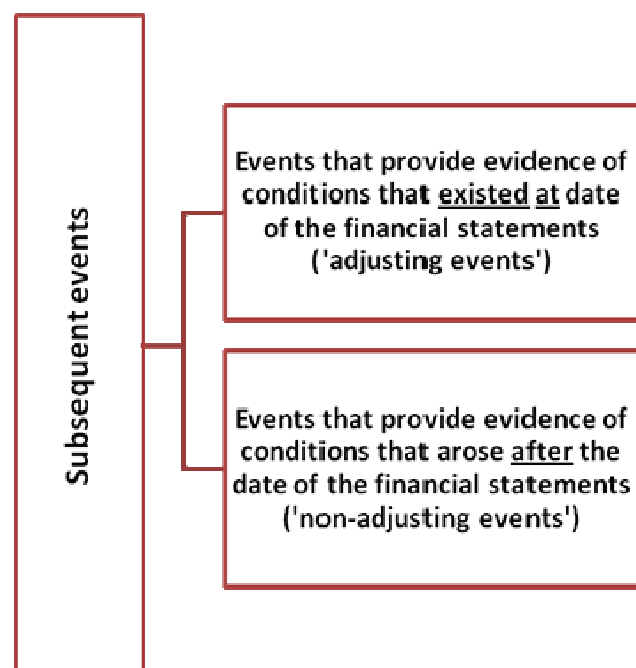
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## Subsequent events

### Overview

- Many financial reporting frameworks identify two types of event:
  - **Adjusting events**
  - **Non-adjusting events**



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## Subsequent events

### Adjusting or Non-adjusting

- Settlement of a court case
- Sale of inventory after year-end providing evidence of its net realisable value at year end
- Dividends declared after the year-end
- Decline in market value of securities held for temporary investment or resale
- Fire causing destruction of major plant
- Fraud or error showing the financial statements are incorrect
- Declaration of bankruptcy due to the deteriorating financial condition of a customer with a large outstanding receivable balance
- Announcement of a major restructuring or acquisition of another enterprise
- Disposal after the date of the financial statements of a large portion of the entity's productive assets
- Subsequent collection of a large accounts receivable which had appeared doubtful of collection at the date of the financial statements

Adjusting	Non-adjusting
✓	
✓	
	✓
	✓
	✓
✓	
✓	
	✓
	✓
✓	

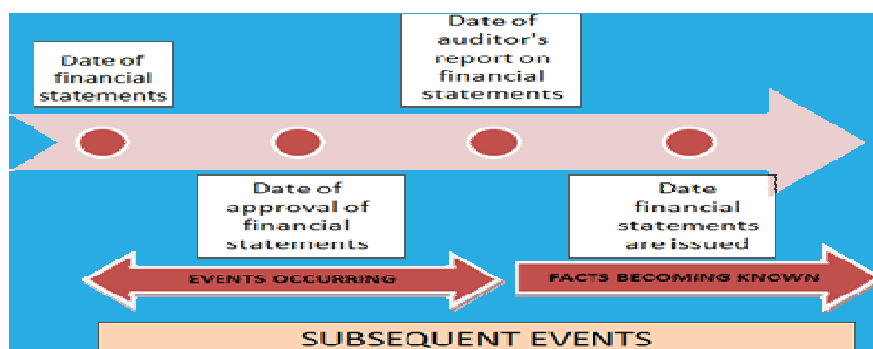


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## Subsequent events



### Audit Objectives

1. Obtain evidence

2. Respond to new facts



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## Subsequent events

HKSA 560 outlines two key objectives in relation to the two types of subsequent events:



- To obtain sufficient appropriate evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of or disclosure in the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework

- To respond appropriately to facts that have become known to the auditor after the date of the auditor's report that had they been known to the auditor at that date may have caused them to amend it



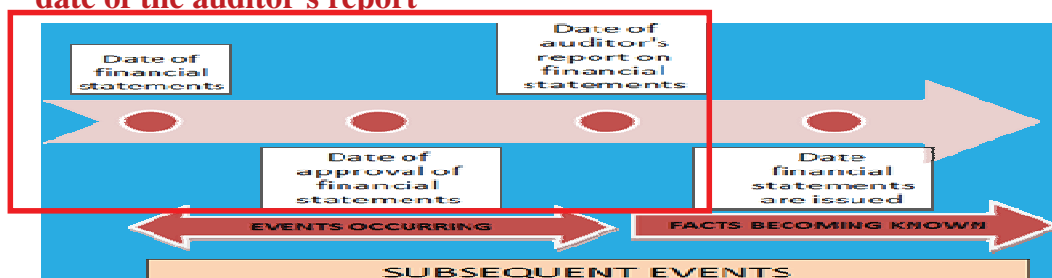
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## Subsequent events

Events occurring between the date of the financial statements and the date of the auditor's report



- HKSA 560 requires the auditor to **perform audit procedures** to obtain sufficient appropriate audit evidence that all events between the financial statements date and the auditor's report date that require adjustment or disclosure have been identified. This will include adjusting and non-adjusting events



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## Scenario example: Subsequent events

### Scenario:

- Olivier Co is a company that manufactures and sells office furniture. Its year end is **31 December 2012**
- Whilst completing the audit, the auditor finds out through inquiry with management that one of the parts of the high specification swivel office chairs has been reported as defective, making the chairs unsafe for use
- The auditor completes the audit and signs the audit report on **15 March 2013** and the financial statements are issued on **20 April 2013**

### What would the auditor need to do?

- As the knowledge of this event was obtained before signing of the auditor's report and impacts the value of inventory at 31 December 2012, the auditor would have to undertake audit procedures to determine if there was a material impact on the financial statements

### This could include:

- contacting the representatives of the parts supplier to **confirm whether refunds are to be expected**
- **reviewing inventory lists** to ensure that defective parts were not used in any other products
- **reviewing correspondence with legal advisors** to ascertain the impact of the recall process and whether there are likely to be claims for chairs already sold



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## Scenario example: Subsequent events

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- The auditor completes the audit and signs the audit report on **15 March 2013** and the financial statements are issued on **20 April 2013**

### What would the auditor need to do (cont'd)?

- **obtaining documentation from the insurers** confirming their estimate of the value of inventory that is covered through insurance
- obtaining an **additional written representation** confirming the accuracy of the amounts written off and confirming that no other items of inventory are affected

If the financial statements needed amending, the auditor would request amendment. If management did not agree, the auditor would need to determine the impact on the audit opinion



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## What procedures could the auditor undertake to test subsequent events?

### Audit procedures to test subsequent events

#### Inquiries of management or those charged with governance

- **Inquire** as to status of items involving **subjective judgment**
- **Confirm** status of items accounted for using **preliminary or inconclusive** data or unusual adjustments
- **Investigate** whether there are any new **commitments, borrowings or guarantees**
- **Investigate** whether there have been any:
  - **sales** or destruction of **non-current assets**
  - **issues** of **shares/debentures** or changes in business structure
  - **developments** involving high **risk areas, provisions and contingencies**
  - **Unusual accounting adjustments**
  - **Major events** affecting appropriateness of accounting policies for estimates
  - **Litigation** or claims to indicate potential contingent liabilities
  - Significant **changes in the assets or capital structure of the entity**

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## What procedures could the auditor undertake to test subsequent events?

### Audit procedures to test subsequent events (cont'd)

#### Other procedures

- **Review** management procedures for identifying subsequent events to ensure that management are aware of the risks
- **Perform procedures** which usually form part of the verification of year-end account balances e.g. **cut-off and valuation tests** of various balances and related transactions
- **Review internal documents such as board and committee meeting minutes.** Inquire about unusual items
- **Review latest available interim financial statements and budgets, cash flow forecasts and other management reports.** Inquire or extend previous oral or written inquiries of the entity's legal counsel concerning litigation and claims

## What procedures could the auditor undertake to test subsequent events?

### Audit procedures to test subsequent events (cont'd)

#### Other procedures

- **Obtain evidence** concerning any litigation or claims from the entity's counsel (but only with the entity's permission). This may include correspondence with or confirmation letters from lawyers
- Obtain **written representation** that all events occurring subsequent to the date of the financial statements which need adjustment or disclosure have been adjusted or disclosed



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## Scenario example: Subsequent events

### Scenario (cont'd):

- On **31 March 2013**, the Government's Health & Safety Executive, responsible for ensuring compliance with health and safety legislation, issue a report stating that Olivier Co is in breach of this legislation in its manufacturing plant and fines Olivier \$300,000 which is material to the financial statements



**What is the auditor's responsibility on this event?**



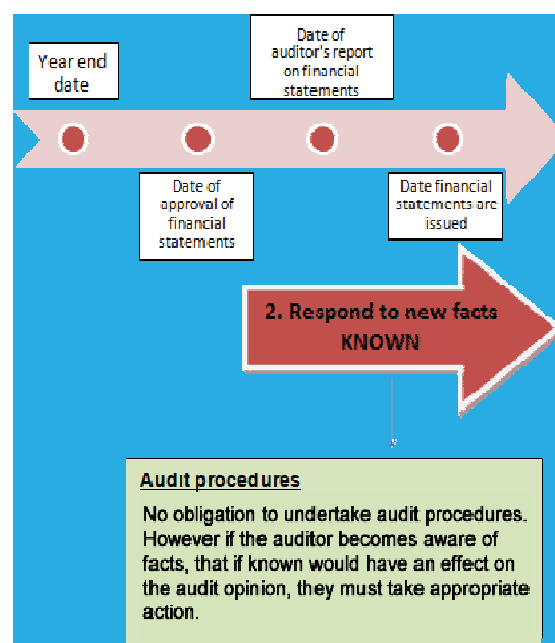
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## Facts becoming known after the date of the auditor's report but before the financial statements are issued

- HKSA 560.10 states that the auditor has no obligation to perform any audit procedures regarding financial statements after the date of the auditor's report
- However, if, after the date of the auditor's report but before the date the financial statements are issued, the auditor becomes aware of a fact that would have altered the auditor's report had it been known to the auditor at the date of the auditor's report, the auditor will need to take certain actions



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## What are the requirements of HKSA 560.10-11 ?

### Required actions

- **Discuss** the matter with management and TCWG
- **Determine** whether the financial statements need amendment and if so, **inquire** how management intends to address the matter in the financial statements
- **If management amends the financial statements:**
  - Carry out the audit procedures necessary in the circumstances on the amendment
  - Unless the circumstances in HKSA 560.12 apply:
    - extend the subsequent event audit procedures to the date of the new auditor's report; and
    - provide a new auditor's report on the amended financial statements
    - the new auditor's report shall not be dated earlier than the date of approval of the amended financial statements



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## What are the requirements of HKSA 560.12 ?

### Required actions

- Where law, regulation or the financial reporting framework **does not prohibit** management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements **are not prohibited** from restricting their approval to that amendment, **the auditor is permitted to restrict the audit procedures on subsequent events required to that amendment**. In such cases, the auditor shall either:
  - Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or
  - Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements



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## Dual Dating [HKSA 560.A12]

### Required actions

- When, in the circumstances described in paragraph 12(a), the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements
- Illustration of such an additional date:  
  
(Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y)



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## What if management does not amend the financial statements in circumstances where the auditor believes they need to be amended (HKSA 560.13)?

### Required actions



- if the auditor's report has not yet been provided to the entity, the auditor shall **modify the opinion** and issue its report based on that opinion emphasising the reason for qualification
- if the auditor's report has already been provided to the entity, the auditor shall **advise management and those charged with governance not to issue the financial statements before the amendments are made**. **If the entity refuses**, the auditor shall take action to seek to **prevent reliance** on the auditor's report. The precise action taken will depend on the auditor's legal rights and obligations and the advice of the auditor's legal counsel



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## Scenario example: Subsequent events

### Scenario (cont'd):

- On **31 March 2013**, the Government's Health & Safety Executive, responsible for ensuring compliance with health and safety legislation, issue a report stating that Olivier Co is in breach of this legislation in its manufacturing plant and fines Olivier \$300,000 which is material to the financial statements

### What would the auditor need to do?

As the auditor's report is signed by this date the auditor would need to discuss the matter with management and TCWG to determine whether they will disclose this fine in the financial statements. If they agree to include the disclosure, the auditors will need to audit the amendment and then redraft and reissue the audit report as appropriate for inclusion prior to the issue of the financial statements.

However if management decides not to include the required disclosure in the financial statements, the auditor would need to consider taking action to prevent reliance on the auditor's report eg, speaking at the annual general meeting where the financial statements would be presented



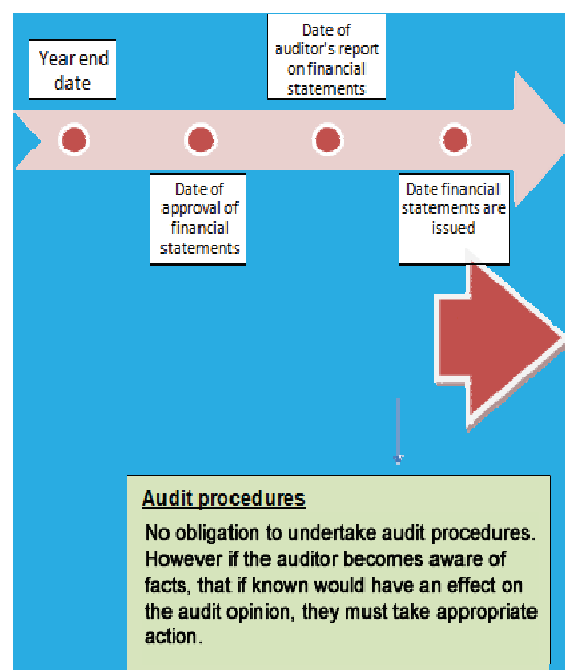
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## Facts becoming known after the financial statements are issued

- HKSA 560.14 states that after the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements
- However, if the auditor becomes aware of a fact, that if known would have altered the auditor's report, the auditor will need to take certain actions



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## What are the requirements of HKSA 560.14?

### Required actions

- **Discuss** the matter with management and TCWG
- **Determine** whether the financial statements need amendment and if so,
- **Inquire** how management intends to address the matter in the financial statements
- **If management amends the financial statements**, the auditor shall:
  - **carry out the audit procedures** necessary in the circumstances on the amendment
  - **review the steps taken by management** to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report is **informed** of the situation



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## What are the requirements of HKSA 560.14?

- **If management amends the financial statements**, the auditor shall (cont'd):
  - unless the circumstances in HKSA 560.12 apply:
    - extend the audit procedures to the date of the new auditor's report, and date the new auditor's report no earlier than the date of approval of the amended financial statements; and
    - provide a new auditor's report on the amended financial statements
  - When the circumstances in HKSA 560.12 apply, amend the auditor's report, or provide a new auditor's report as required by HKSA 560.12



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## What if management did not take the necessary steps ?

- If the auditors feel management has failed to adequately communicate the fact that the financial statements have been amended to users, the auditor shall **notify** management and those charged with governance that the auditor will **seek to prevent future reliance** on the report through legal recourse
- In the public sector, when management does not amend the financial statements, auditors may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report

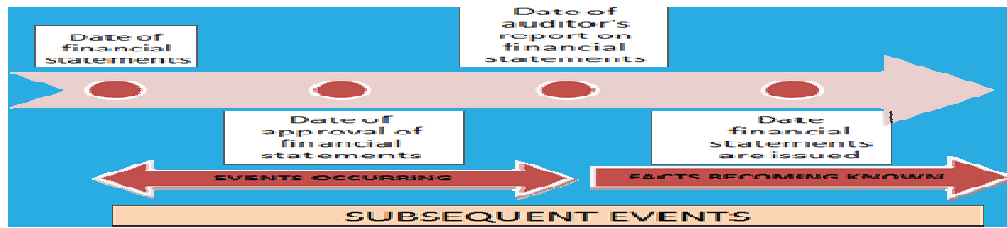


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## Reminders:



- ✓ HKSA 560 *Subsequent events* outlines the key requirements for auditors in relation to events that occur after the financial statements date
- ✓ Audit procedures will depend on when the event occurs or fact comes to light
- ✓ Auditors have an active duty to perform procedures to identify all events to the date of the auditor's report that require adjustment or disclosure in the financial statements



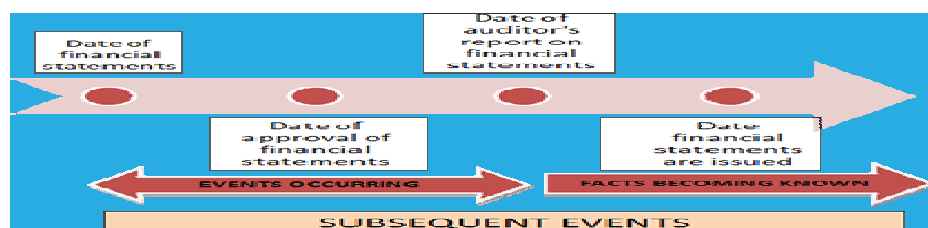
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## Reminders (contd'):

- ✓ After the auditor's report the auditor has no obligation to perform any audit procedures regarding the financial statements. However the auditor still has a passive duty so that if facts come to light which would have impacted the auditor's report, the auditor must take various actions to ensure reliance on the financial statements is appropriate. The actions will depend on when the facts come to light; before the date the financial statements are issued or after



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## PART 2

# Going Concern



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## Going concern....

- General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so...



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## Going Concern

*What does going concern mean?*

*Why is assessing going concern so important?*

*Management's responsibilities versus auditor's objective in assessing going concern?*



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## **What are we going to learn?**

- ✓ the auditor's responsibilities relating to management's use of the going concern assumption in the preparation of financial statements
- ✓ the requirement to ascertain whether a material uncertainty exists related to events or conditions that cast significant doubt on the entity's ability to continue as a going concern
- ✓ the different reporting implications based on the evaluation on the appropriateness of the use of going concern assumption and the disclosure of any material uncertainty



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# Going concern assumption



## What does going concern mean?

- Under the **going concern assumption**,  
an entity is viewed as continuing in business for the foreseeable future with neither the intention to liquidate or cease trading or has no realistic alternative
- When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business



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# Management's responsibilities



- It is **management's responsibility to make assessment** on whether the entity can continue as a going concern, **not the auditor's responsibility**
- When management is aware of material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern, uncertainties should be disclosed

When management makes the assessment, it will consider:

- The **uncertainty** involved about the events and conditions being assessed
- **Judgment** made based on the available information at that time and the future
- The **size and complexity** of the entity, the **nature and condition** of the entity



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## Auditor's objectives

Given that an auditor is providing an opinion as to whether the financial statements are free from material misstatement, **HKSA 570** *Going Concern* states the auditor's objectives as follows:

- to obtain sufficient appropriate evidence regarding the **appropriateness** of management's use of the **going concern assumption**;
- to conclude whether there is **material uncertainty** that casts doubt over the entity's ability to continue as a going concern;
- to determine any **implications** for the **audit report**



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## Why is going concern assessment so important?



- Users of such financial statements need confidence that when they read the financial statements, management is not hiding any uncertainty about the future viability of the entity

- Judgements regarding the valuation of assets in the financial statements depend on the entity's ability to continue to trade for the 'foreseeable future'
- If an entity is unlikely to exist for more than 12 months then the need to liquidate assets (possibly in a distressed situation) may have a significant impact on the value of their assets, which will need to be reflected in the financial statements



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## How can the auditor achieve its objective in practice?

- For the auditor to obtain sufficient appropriate evidence, procedures will be required at each of the three phases of the audit :

Phase 1	Risk Identification and assessment
Phase 2	Responding to risk
Phase 3	Evaluation and reporting



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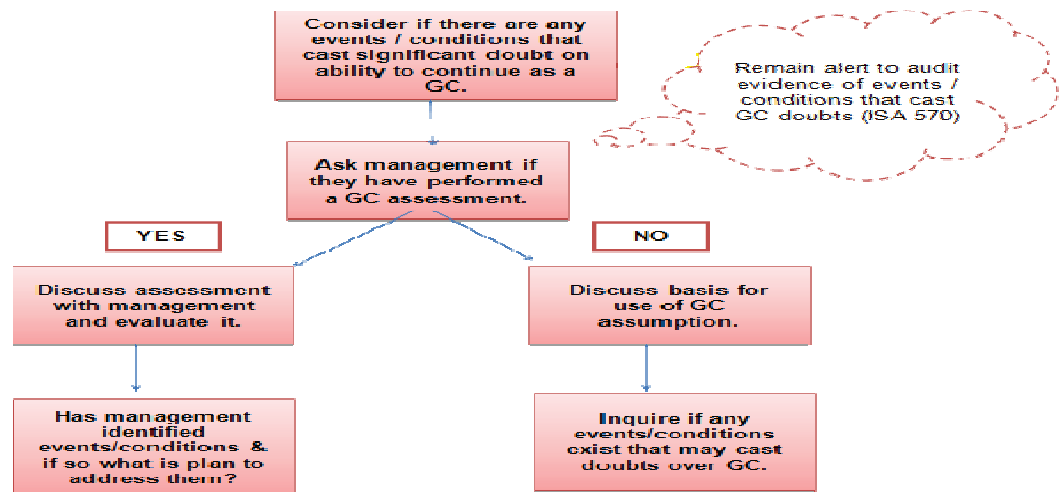
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## What are the requirements of HKSA 570?

When performing risk assessment procedures as required by HKSA 315, the auditor shall consider whether there are **events or conditions** that **may cast significant doubt on the entity's ability to continue as a going concern (GC)**

### Risk identification and assessment



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## Scenario example: Going concern

### Scenario:

- Due to the reduction in the repairs business, Co A has decided to close the workshop and sell the inventory of equipment and spares
- During the year the company replaced a number of vehicles, funding them by a combination of leasing and an increased overdraft facility. The facility is to be reviewed early next year after the audited accounts are available
- The draft accounts show a loss for the current year but the forecasts indicate a return to profitability next year, as the managing director is optimistic about generating additional revenue from new contracts

**What events/conditions are present that could cast significant doubt over the ability of Co A to continue as a going concern?**

#### Financial indicators:

- Significant reduction in revenue and gross profit
- Trading loss
- Cash flow difficulties
- Overdraft facility due for review
- Financing new vehicles through leasing

#### Operational indicators:

- Loss of long standing customer
- Decline in trade in another segment of the business
- Decision to shut repairs business

#### Potential mitigating factors:

- Cash flow released from sale of inventory, equipment and spares
- Potential new contracts in new year
- Willingness of banks to extend overdraft this year
- Favourable forecasts



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## What are the requirements of HKSA 570 ?

What are events/conditions that could cast significant doubt over the going concern assumption?

### Going concern indicators

#### Financial

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- Excessive reliance on short-term borrowings to finance long-term assets
- Withdrawal of financial support by creditors, holding entity and shareholders
- Negative operating cash flows
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments



## What are the requirements of HKSA 570 ?

### Going concern indicators

What are events/conditions that could cast significant doubt over the going concern assumption (cont'd)?

#### Operating

- Management intentions to liquidate or cease operations
- Loss of key management without replacement
- Loss of a major market, key customers, licence or principal suppliers
- Emergence of a highly successful competitor

#### Others

- Non-compliance with capital or other statutory requirements
- Pending legal or regulatory proceedings against the entity
- Changes in law or regulations that may adversely affect the entity



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## What are the requirements of HKSA 570?

### Evaluating management's assessment

According to HKSA 570, if management has prepared an assessment of the entity's ability to continue as a going concern, then the auditor must discuss it with management and evaluate it

*What will this evaluation involve?*

- The auditor shall consider whether management's assessment includes all relevant information for the auditor's evaluation
- In addition, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable reporting framework, that is HKAS 1 or by law or regulation if it is specific a longer period



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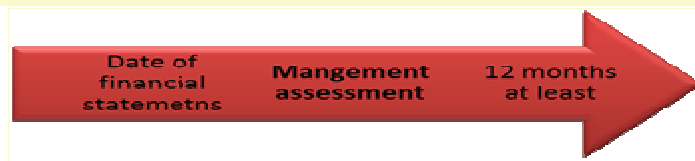
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## What are the requirements of HKSA 570 ?

### Evaluating management's assessment

*The period of management's assessment?*

- The auditor will need to check that management's assessment covers a period of at least 12 months from the date of the financial statements and if it does not, the auditor will have to request management to extend their assessment
- If management is unwilling to extend its assessment as requested, the auditor shall consider the implications for their report



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## What are the requirements of HKSA 570 ?

### Evaluating management's assessment

*Period beyond management's assessment*

- HKSA 570 requires that the auditor shall inquire of management as to its knowledge of events or conditions beyond the period of a management's assessment that may cast significant doubt on the entity's ability to continue as a going concern. **The auditor has no responsibility to perform other audit procedures apart from inquiry**
- In case there are events and conditions identified, the auditor may need to request management to evaluate the potential significance of the event or condition on management assessment
- The auditor shall consider the degree of uncertainty associated with these events and conditions before considering taking further actions



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## What are the requirements of HKSA 570 ?

### Evaluating management's assessment

*Evaluating management's plans in smaller entities*

- Management of smaller entities may not have prepared a detailed assessment of the entity's ability to continue as a going concern. They may rely instead on their in-depth knowledge of the business and anticipated future prospects

For this reason management has not performed an in depth analysis to support its assessment of going concern

Does this mean that the auditor cannot conclude whether use of the going concern assumption is appropriate?



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## What are the requirements of HKSA 570 ?

### Evaluating management's assessment

*The extent of work will depend on circumstances and is not purely dependent on the amount of analysis that management gives the auditor as support to their assessment*

• Evaluate management's process

• Corroborate assumptions

• Corroborate management plans

• Review feasibility of plans



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## What are the requirements of HKSA 570 ?

### Risk response

If going concern events or conditions are identified that cast significant doubt over the entity's ability to continue as a going concern, the auditor will need to respond by undertaking additional audit procedures, including consideration of mitigating factors



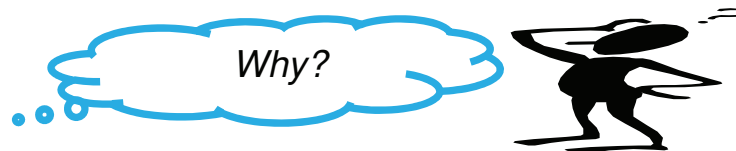
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## What are the requirements of HKSA 570 ?

### Risk response



- To determine if a material uncertainty exists that will need disclosure

- This is an uncertainty related to events or conditions that cast significant doubt on the entity's ability to continue as a going concern due to the potential impact and likelihood of its occurrence
- It casts doubt significant enough that in the auditor's judgement appropriate disclosure should be made of the nature and implications of the uncertainty



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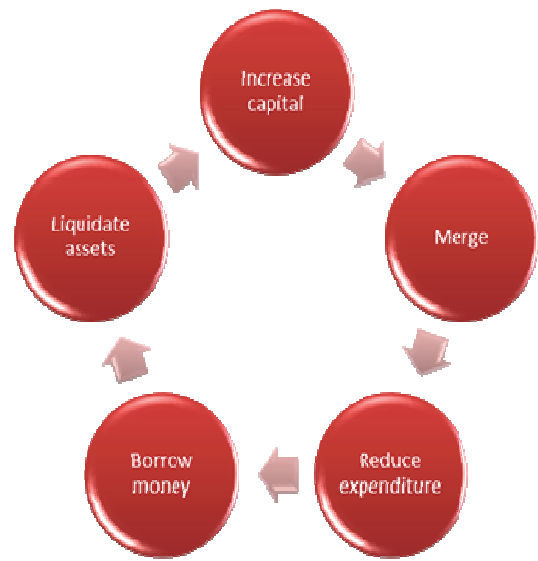
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## What are the requirements of HKSA 570 ?

### Risk response

*Examples of mitigating factors on management's action plans to address going-concern*



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## What further procedures could the auditor undertake to determine if a material uncertainty exists?

### Auditor's steps to address going-concern issues:

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>▪ <b>Obtaining management's assessment and plan</b></li> </ul> | <ul style="list-style-type: none"> <li>▪ If not already provided, request management to make an assessment of the entity's ability to continue as a going concern</li> </ul>   |
| <ul style="list-style-type: none"> <li>▪ <b>Evaluating management's plans of action</b></li> </ul>    | <ul style="list-style-type: none"> <li>▪ Evaluate management's future actions to address the going-concern assessment:               <ul style="list-style-type: none"> <li>▪ will outcome of plans improve the situation?</li> <li>▪ are the plans feasible under the circumstances?</li> <li>▪ how reliable are the profit/cash-flow forecasts, and what support is there for the assumptions used?</li> <li>▪ identify, discuss and obtain evidence for other factors that may affect the entity's ability to continue as going concern, such as:                   <ul style="list-style-type: none"> <li>▪ poor recent operating results;</li> <li>▪ breaches in terms of debentures and loan agreements;</li> <li>▪ references in meeting minutes to financing difficulties;</li> <li>▪ existence of litigation/claims and estimates of financial implications;</li> <li>▪ existence, legality, and enforceability of arrangements to provide or maintain financial support with related and third parties;</li> </ul> </li> </ul> </li> </ul> |



## What further procedures could the auditor undertake to determine if a material uncertainty exists?

### Auditor's steps to address going-concern issues:

- **Evaluating management's plans of action (cont'd)**
  - confirm the existence, terms, and adequacy of borrowing facilities
  - confirm the outcome on reports on regulatory actions
  - Also consider the impact of any additional facts or information since the date management made its assessment and plans
- **Written representations**
  - Request written representations from management (and those charged with governance) regarding their plans for future action and feasibility

Based on the evidence obtained, the auditor should determine if a material uncertainty exists related to the events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

If it is material, the financial statements should adequately describe the principal events or conditions that give rise to the uncertainty about the continuance as a going concern and management's plan to deal with it



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## What are the requirements of HKSA 570 ?

### Evaluation and reporting

The final step is for the auditor to evaluate the audit evidence obtained and determine whether:

- ✓ the going concern assumption is inappropriate
- ✓ the going concern assumption is appropriate but material uncertainty exists and is disclosed properly
- ✓ the going concern assumption is appropriate and no material uncertainty exists
- ✓ the going concern assumption is appropriate but material uncertainty exists and is not disclosed properly



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## What are the requirements of HKSA 570 ?

If adequate disclosures are made in the financial statements of:

### Evaluation and reporting

- principal **events or conditions** that may **cast significant doubt** on the entity's ability to continue as a going concern
- **management's plans** to deal with these events or conditions
- that a **material uncertainty exists**
- the entity may **be unable to realise its assets and discharge its liabilities** in the normal course of business

- The auditor shall express an **unqualified opinion and include an emphasis of matter paragraph** to:
  - highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to
  - draw attention to the note in the financial statements that disclose the matter
  - For multiple material uncertainties that are significant to the financial statements as a whole, the auditor may consider it appropriate to express a **disclaimer of opinion** instead



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## What are the requirements of HKSA 570 ?

### Evaluation and reporting

If the auditor concludes that the use of the going concern assumption is appropriate but a material uncertainty exists and there is **inadequate disclosure** in the financial statements

- The auditor shall express a **qualified opinion or adverse opinion** in accordance with HKSA 705 *Modifications to the opinion in the independent Auditor's Report*



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## What are the requirements of HKSA 570 ?

### Evaluation and reporting

If the financial statements have been prepared on a going concern basis, but in the auditor's judgment this is **inappropriate**, the auditor must express **an adverse opinion**

This applies regardless of whether the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption



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## What are the requirements of HKSA 570 ?

### Evaluation and reporting

In certain circumstances, the auditor may believe it necessary to **request management to make or extend its assessment**. If management is unwilling to do so, **a qualified opinion or a disclaimer of opinion** in the auditor's report may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding the use of the going concern assumption in the preparation of the financial statements



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## What are the requirements of HKSA 570 ?

### Evaluation and reporting

In the entity's management is required or elects to prepare financial statements the use of the going concern assumption is not appropriate in the circumstances, the financial statements are prepared on an **alternative basis** such as the liquidation basis. The auditor can still perform the audit provided that the auditor determines the alternative basis is an acceptable financial reporting framework in the circumstances

The auditor can still issue an **unmodified opinion** on those financial statements if adequate disclosure has been made and an **emphasis matter paragraph** may be added to draw reader's attention to that alternative basis and the reasons for its use



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## What are the requirements of HKSA 570 ?

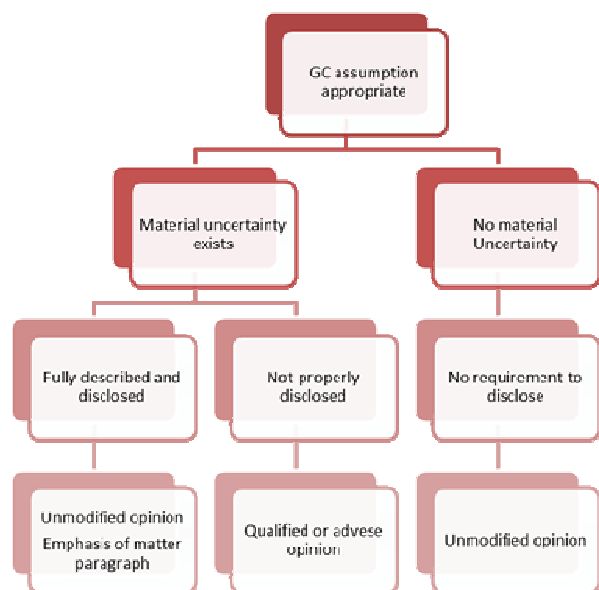
### Evaluation and reporting

#### Evaluate

GC assumption inappropriate

GC assumption appropriate  
No material uncertainty exists

GC assumption appropriate  
Material uncertainty exists



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## What are the requirements of HKSA 570 ?

Communicating with those  
charged with governance

Unless management and TCWG are the same, the auditor must communicate to TCWG, events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

Communication should include whether the:

- event / condition is a material uncertainty
- use of GC assumption appropriate
- disclosures are adequate



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## For your reference



Refer to Annex 1 for an  
example of going concern  
documentation



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## Reminders:

- ✓ The going-concern assumption is fundamental to the preparation of financial statements
- ✓ If an entity is likely to liquidate in the period shortly after the reporting date, it would be inappropriate to prepare the financial statements on the going concern basis as it may give users a distorted view of the financial position and prospects of the entity
- ✓ If the entity has inappropriately used the going concern assumption or a material uncertainty exists, this may impact on the auditor's report
- ✓ HKSA 570 *Going concern* outlines the key requirements for auditors when considering management's use of the going concern assumption to prepare the financial statements



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## Reminders:

- ✓ When the auditor performs risk assessment procedures, the auditor has to consider whether there are events or conditions that cast significant doubt on an entity's ability to continue as a going concern
- ✓ The risk assessment procedures will include evaluating management's own assessment of the entity's ability to continue as a going concern
- ✓ If events or conditions are identified that do cast significant doubt on the entity's ability to continue as a going concern, then the auditor must perform further additional procedures to determine whether there is a material uncertainty in relation to the events/conditions which must be disclosed and described fully in the accounts
- ✓ The auditor must assess findings to determine the implications for the audit report



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# Agenda of today

1. Recap on audit procedures
2. Subsequent events and going concern
3. Use the work of an auditor's expert and/or internal auditors
4. Group audits
5. Physical inventory count
6. Initial engagement and comparatives
7. Audit documentation



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## PART 5

# Physical inventory counting



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# Inventories

## Key financial statement assertions

Assertions	Classes of transactions	Account balances	Presentation and disclosure
Existence/ occurrence	✓ (occurrence)	✓ (existence)	✓ (occurrence)
Completeness	✓	✓	✓
Rights and obligations		✓	✓
Accuracy	✓		✓
Cutoff	✓		
Classification and understandability	✓		✓
Valuation/ allocation		✓	✓



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# Inventories

## Physical inventory count

- **HKSA 501** Audit Evidence – Specific Considerations for selected Items

▪ *"When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable. The auditor's attendance serves as a test of controls or substantive procedure over inventory depending on the auditor's risk assessment and planned approach."*

- **Types of inventory counts**

1) Physical inventory count at the year-end

2) Continuous (Perpetual) inventory

3) Physical inventory count before or after the year-end



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# Inventories

## 1) Physical inventory count at the year end

What are the procedures that we need to do / consider in each of the following steps?

A) Planning inventory count

B) Attending at inventory count

C) After the inventory count



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# Inventories

## 1) Physical inventory count at the year end

A) Planning inventory count

HKSA 501.A3 states that:

*In planning attendance at the physical inventory count or the alternative procedures, the auditor considers the following:*

- ✓ The **risks of material misstatement** related to inventory
- ✓ The nature of **internal control** related to inventory
- ✓ Whether adequate procedures are expected to be established and **proper instructions** issued for physical inventory counting
- ✓ The **timing** of the count
- ✓ The **locations** at which inventory is held
- ✓ Whether an **expert's assistance** is needed



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# Inventories

## 1) Physical inventory count at the year end

### A) Planning inventory count

HKSA 501.A4 further states that:

*The auditor would review management's instructions regarding:*

- (a) The **application of control activities**, for example, collection of used stocksheets, accounting for unused stocksheets and count and re-count procedures;*
- (b) Accurate **identification of the stage of completion of work in progress**, of **slow moving, obsolete or damaged items** and of **inventory owned by a third party**, for example, on consignment;*
- (c) The procedures used to **estimate physical quantities**; and*
- (d) **Control over the movement** of inventory between areas and the shipping and receipt of inventory before and after the cutoff date*



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# Inventories

## 1) Physical inventory count at the year end

### A) Planning inventory count

The client has several warehouses over the PRC. Do we need to perform the count in every warehouse?

How can we make sure the valuable diamonds and watches are those appeared on the stock list?

Practical Questions

My client owns coal mines. How can we perform the count?

How many samples do we need to select for inventory count?



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# Inventories

## 1) Physical inventory count at the year end

### A) Planning inventory count



- If physical inventory count is carried out as test of details, sampling method can be used to determine the sample size
- HKSA 530.A11 states that "*the sample size can be determined by the application of a **statistically-based formula or through the exercise of professional judgment***"
- It will be also appropriate to use **stratification or value-weighted selection** when selecting the samples

Annex 5 provides further points that the auditor should consider when planning the inventory count



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# Inventories

## 1) Physical inventory count at the year end

### B) Attending at inventory count

- ❑ Observe the count performed by the entity's staff and determine whether the staff are following the entity's instructions
- ❑ Perform **two-way test counts** to ensure the existence and completeness of the inventories.

#### What is a two-way test count?

- ❑ Select items from the management's count records and check to the physical inventory (list-to-floor) → ensure **existence**
- ❑ Select items from the physical inventory to the management's count record (floor-to-list) → ensure **completeness**



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# Inventories

## 1) Physical inventory count at the year end

### B) Attending at inventory count

- ❑ Consider **retaining copies of count records** for subsequent audit procedures and comparison
- ❑ Consider **cutoff** procedures including details of the movement of inventory just **prior to, during** and **after** the count so that the accounting for such movements can be checked at a later date

#### What are the cutoff procedures?

- ❑ If there is NO inventory movement during the count
- ❑ If there is inventory movement during the count



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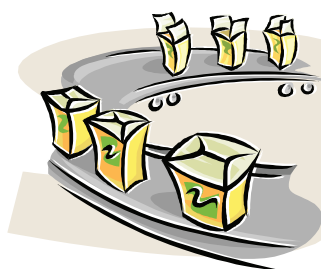
# Inventories

## 1) Physical inventory count at the year end

### B) Attending at inventory count

- ❑ Observe the procedures in identifying damaged, obsolete and slow-moving inventory → ensure **valuation**
- ❑ Arrange direct confirmations for inventories held on behalf of third parties → ensure **rights and obligations**

**Annex 5** provides further points that the auditor should consider when attending at the inventory count.



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# Inventories

## 1) Physical inventory count at the year end

### C) After the inventory count

- ❑ Performs **audit procedures over the final inventory listing to determine whether it accurately reflects actual inventory counts**. For example, trace items from the count sheet to the final inventory records
- ❑ **Ensure proper cut-off** by checking sale invoices/delivery notes and supplier invoices / goods received notes
- ❑ **Review replies from third parties** for inventory held by or for them.
- ❑ **Follow up on those variances** / problems during the inventory count

**Annex 5 provides further points that the auditor should consider after the inventory count.**



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# Inventories

## 2) Continuous (perpetual) inventory

Usually perform testing of internal controls:

- ✓ All inventory lines are counted at least once a year
- ✓ Maintains adequate inventory records that are kept up-to-date
- ✓ Satisfactory procedures for inventory counts and test-counting. The arrangements and instructions are as rigorous as those for a year-end count, including the cutoff procedures
- ✓ Investigate and corrects all material differences. All corrections to inventory movements should be authorised by a personnel not involved in the physical count
- ✓ Also need to consider further work on completeness and existence at the year-end and investigate any variances between the perpetual record and the physical count

**Annex 6 provides list of possible internal controls that are applicable to inventory**



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# Inventories

## 3) Physical inventory count before or after the year-end

Usually perform **testing of the followings**:

- ❑ Obtain audit evidence about changes in inventory between the count date and the date of financial statements (intervening period) are properly recorded
- ❑ Usually we will perform a **rollback** exercise:
  - Obtain and examine the supporting (e.g. goods received notes & delivery notes) for stock movement during the intervening period
  - Apply these stock movements to the actual results of the physical count to calculate the stock quantity as at the year-end
- ❑ Factors to consider for rollback exercise:
  - The **longer** the intervening period, the **more difficult** the rollback
  - **Highly dependent** on the internal control of inventory movement
  - **Cannot check** on the physical condition of the inventory as at the year-end date



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What if existence of the inventory cannot be verified by a physical count?

Other alternative procedures include:

- examining supporting costing records
- checking the purchase and subsequent sales supporting
- testing internal controls

We can also compare the level of inventory movement with that of prior years and investigate unusual fluctuations. For example, any exceptionally high sales volume near the year end.



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If there are a lot of errors found in the inventory count and there is no proper reasons for such variances, what should we do?

If **audit sampling** is used in the test of details, when **the projected misstatement plus anomalous misstatement**, if any, **exceeds tolerable misstatement**, the sample does not provide a reasonable basis for conclusions about the population that has been tested. Considering the results of other audit procedures helps the auditor to assess the risk that actual misstatement in the population exceeds tolerable misstatement, and the risk may be reduced if **additional audit evidence is obtained**. Sometimes, the auditors may request that the **inventory be recounted**.



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There was one sample that **did not match with the count** performed by the client. The client told me that the stock has just been delivered from the warehouse to the factory. When I request for the **related delivery notes from the warehouse**, the client said it **was lost**. Should I choose another sample to replace this one?

In such case, we should see if **alternative procedures**, such as checking goods received notes of factory or/ and goods received notes of warehouse to show that the stock was held by the entity as at the year end. If the designed and alternative procedures cannot be applied, the auditor shall treat it as **misstatement in this test of details**. The auditor should investigate the nature and cause of misstatement and evaluate their effect to the audit.



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# Inventories

For inventory held by third party,

- obtain **direct confirmation from the third party** as to the quantities and condition of inventory held on behalf of the entity
- Depending on materiality of this inventory the auditor would also consider the following:
  - The **integrity and independence** of the third party
  - Observing, or arranging for another auditor to observe, **the physical inventory count**
  - **Obtaining another auditor's report** on the adequacy of the third party's internal control for ensuring that inventory is correctly counted and adequately safeguarded
  - **Inspecting documentation** regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral



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# Inventories

## Valuation of the inventory

**HKAS 2 Inventories para 9 states that:  
Inventories shall be measured at the lower of cost and net  
realisable value**

How can we check the net realisable value?

- **Net realisable value** = estimated selling price less estimated cost of completion and estimated selling costs
- **Estimated selling price** can be checked against the records of subsequent sales after the year end
- However, the following points should also be considered:
  - Subsequent sale quantities vs stock level
  - Shelf life of inventory
  - Any contractual sales?
  - Any introduction of new products which make existing product obsolete?



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# Inventories

## Substantive analytical procedures

- Stock turnover ratio  
= Trade purchases / stock  
= (Stock / trade purchases) x 365 days
- Stock analysis over types of products; locations; periods (seasonal fluctuations); provisions

## Testing internal controls

- Annex 6 provides a list of some possible internal controls for inventory



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## PART 6

# Initial engagements and Comparatives

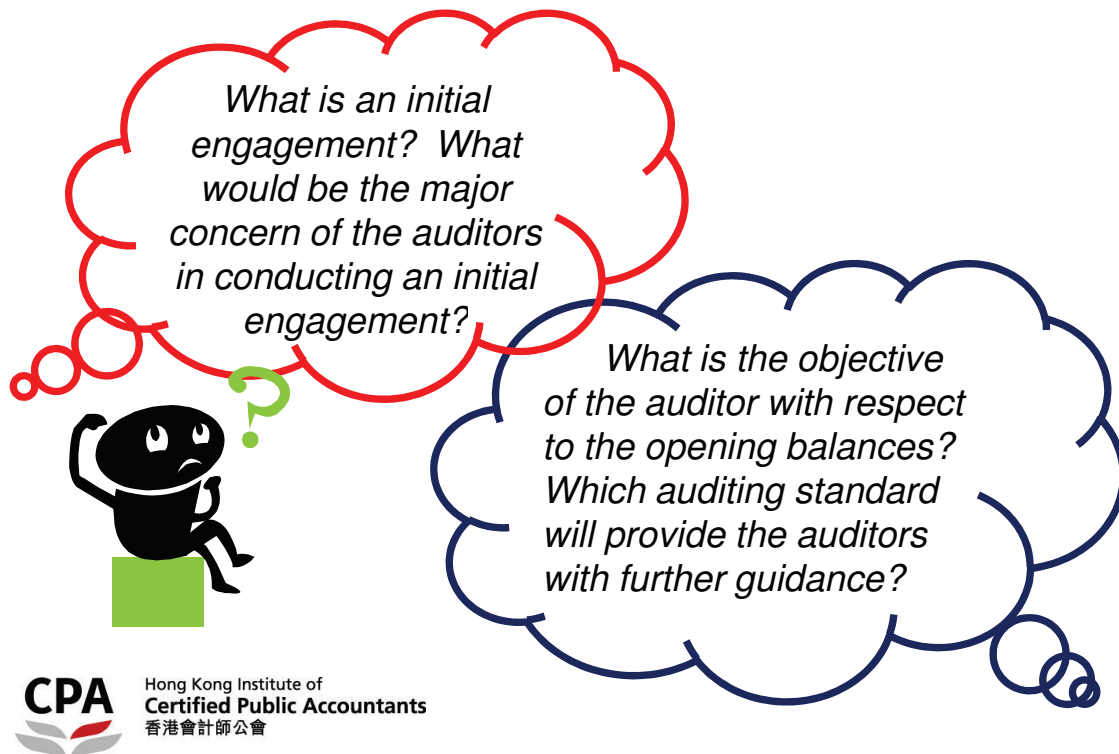


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# Initial Audit Engagements



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## Initial Audit engagements

### Overview

- The auditor may conduct an initial audit engagement when the financial statements for the prior period **were not audited** or when the financial statements for the prior period were **audited by a predecessor auditor**, meaning the incoming auditor should obtain sufficient and appropriate audit evidence in regarding the opening balances
- HKSA 510** provides guidance regarding opening balances on initial engagements

### Key terms:

**Opening balances** are those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments

**Predecessor auditor** is an auditor from a different audit firm who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor

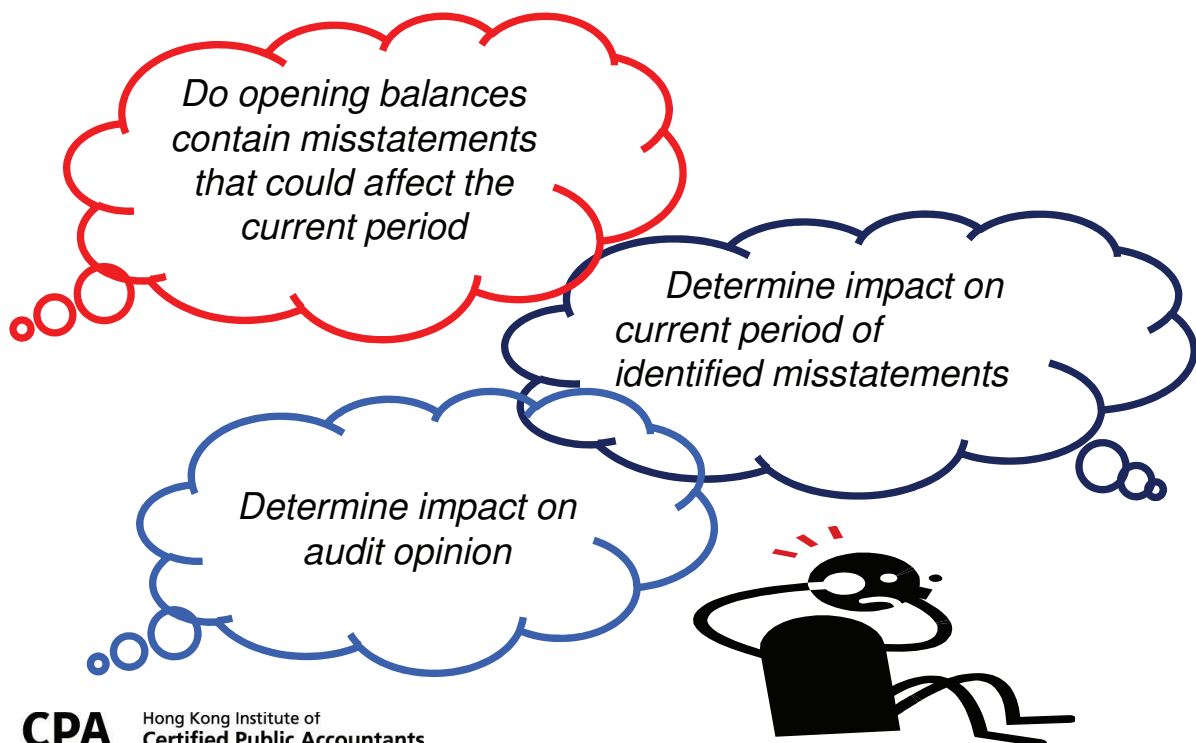
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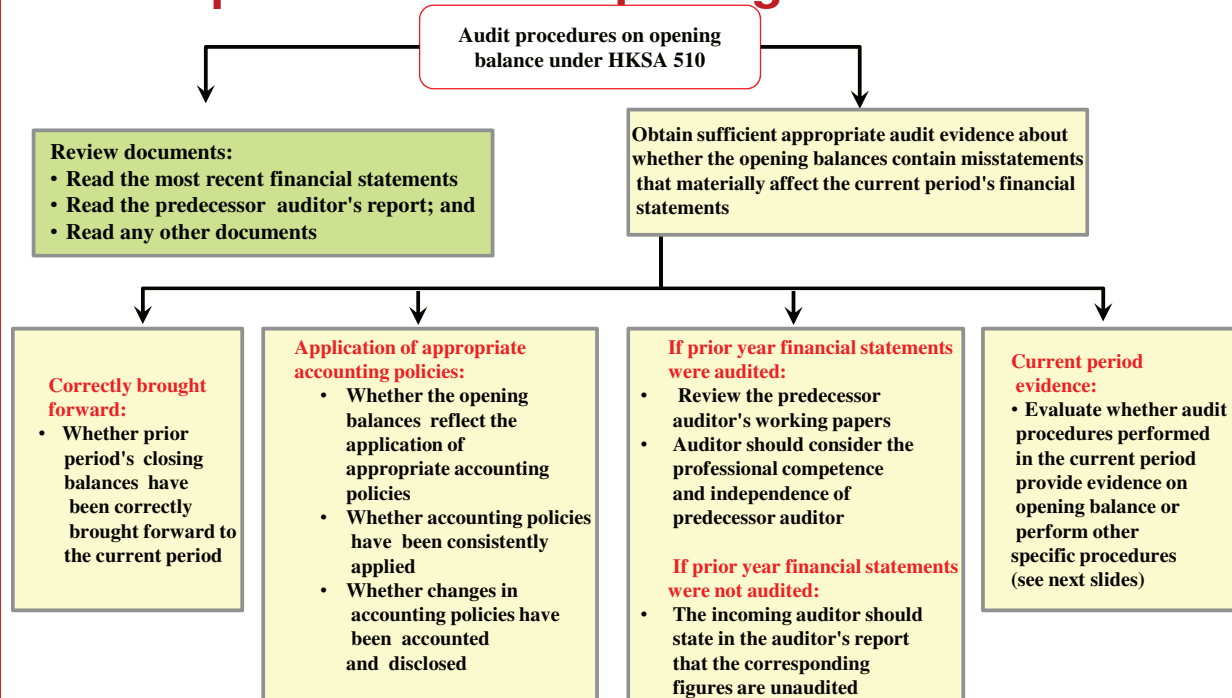
## Auditor's objectives in respect of opening balance

- **HKSA 510** states that when the auditor conducts an initial audit engagement, the objective with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:
  - (a) opening balances contain **misstatements** that materially affect the current period's financial statements
  - (b) appropriate **accounting policies** reflected in the opening balances have been **consistently applied** the current period's financial statements
  - (c) if changes are made, whether these changes are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework

## The auditor needs to address.....



# Audit procedures on opening balances



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## Specific audit procedures

- For **current assets and liabilities** some audit evidence may be obtained as part of the current period's audit procedures. For example, the **collection** (payment) of opening accounts **receivable** (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period



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## Specific audit procedures (cont'd)

▪ In the case of **inventories**, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional procedures may be necessary

**A combination of these procedures may provide sufficient appropriate audit evidence**

- (a) **observing a current physical inventory count and reconciling it back to the opening inventory quantities**
- (b) **performing audit procedures on the valuation of the opening inventory items**
- (c) **performing audit procedures on gross profit and cut-off**



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## Specific audit procedures

- For **non-current assets and liabilities**, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.
- In some situations, the current auditor may wish to hold **consultations with the predecessor auditor**. This is usually limited to seeking information on the predecessor auditor's audit of particular areas (usually high risk areas), or to obtaining clarification of any significant accounting matters that are not adequately dealt with in the client's records.



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## Specific considerations

### What if the opening balances contain misstatements that could affect the current period's financial statements?

If the opening balances contain misstatements that could **affect the current period's financial statements**, the auditor shall **perform additional audit procedures** to determine the effect on the current period's financial statements. In addition, the auditor shall **communicate** the misstatements with the appropriate level of management and those charged with governance

If the auditor concludes that the opening balances contain a **misstatement** that **materially affects** the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor shall express a **qualified opinion or an adverse opinion**, as appropriate



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## Specific considerations

### What if the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion?

HKSA 510 requires that if the prior period's financial statements were audited by a predecessor auditor and there was a **modification to the opinion**, the auditor shall **evaluate the effect** of the matter giving rise to the modification in **assessing the risks of material misstatement** in the current period's financial statements

If the prior period auditor's report was modified, the auditor should **consider the effect on the current period's financial statements**. For example, if there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been **resolved** in the current period, the auditor may not need to modify the current period's audit opinion

If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that **remains relevant and material to the current period's financial statements**, the auditor shall modify the auditor's opinion on the current period's financial statements



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## Specific considerations

**What if the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances?**

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall **express a qualified opinion or disclaim on opinion** on the financial statements, as appropriate



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## Specific considerations

**What if accounting policies are not consistently applied?**

If the auditor concludes that:

- (a) the current period's **accounting policies are not consistently applied** in relation to opening balances in accordance with the applicable financial reporting framework
- (b) a **change in accounting policies** is not appropriately properly accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

**the auditor shall express a qualified opinion or an adverse opinion as appropriate.**

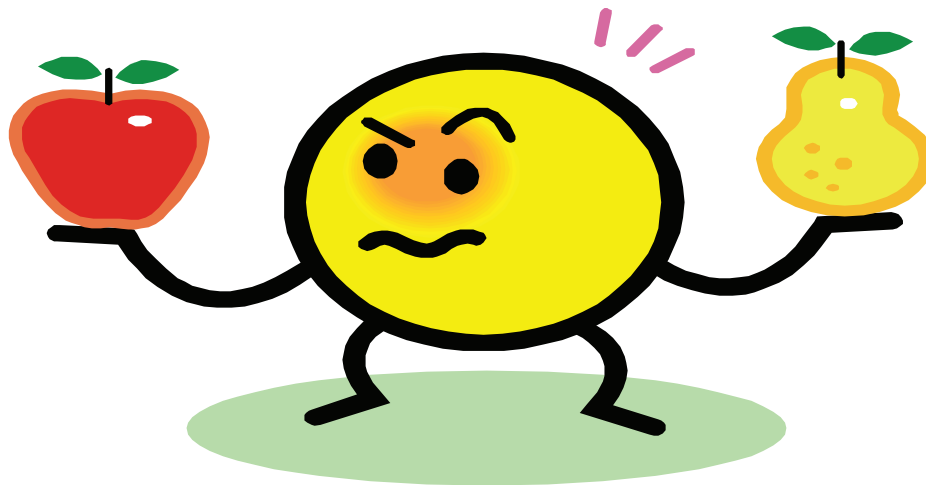


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# Comparatives

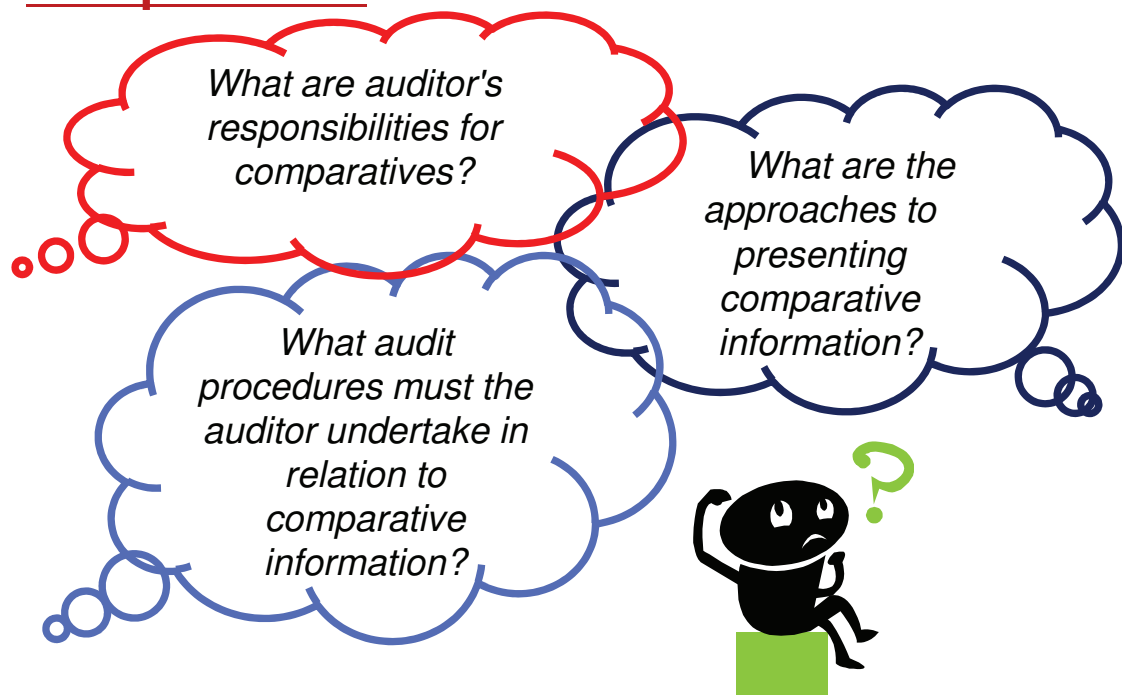


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## Comparatives



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# Comparatives

## Overview

- The **nature** of comparative information presented in an entity's financial statements will depend on the requirements of the **applicable financial reporting framework**
- The auditor's **responsibilities** for comparatives vary depending on whether they are **corresponding** figures or **comparative** financial statements

- **HKSA 710 Comparative Information – Corresponding Figures and Comparative Financial Statements** establishes standards and provides guidance on the auditors' responsibilities regarding comparatives
- The auditor should determine whether the comparatives comply in all material respects with the financial reporting framework applicable to the financial statements being audited



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## Key terms

- **Corresponding figures** are amounts and other disclosures for the preceding period **included as part of the current period financial statements**, which are intended to be read in relation to the amounts and other disclosures relating to the current period
- **Comparative financial statements** are amounts and other disclosures of the preceding period included for comparison with the financial statements of the current period, but **do not form part of the current period financial statements**

Comparatives are presented in compliance with the relevant financial reporting framework. The essential audit reporting differences are that:

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



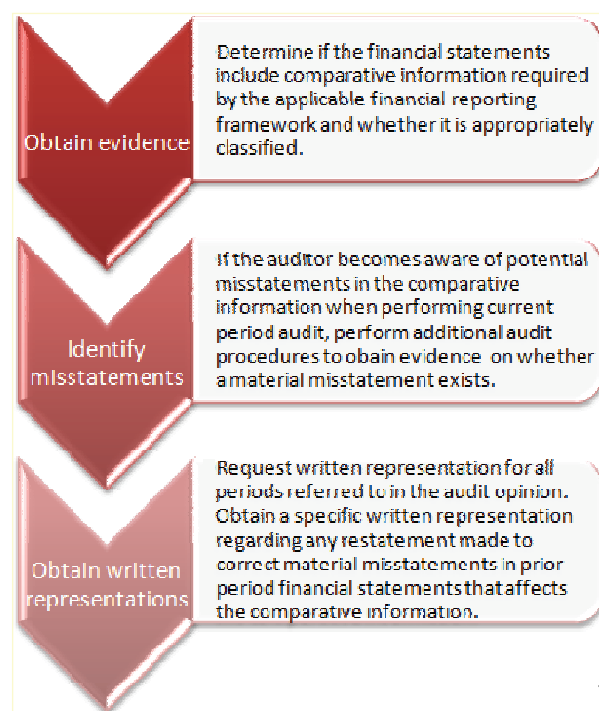
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## What audit procedures must the auditor undertake in relation to comparative information?

- **HKSA 710** *Comparative information* requires the auditor to undertake the procedures shown in the diagram in order to obtain sufficient appropriate evidence on whether the comparative information included in the financial statements is free from material misstatement



## Reporting responsibilities

- The auditor's reporting responsibilities will differ slightly depending on the nature of the comparative information in the following areas
  - Reference to period
  - Restatement required?
  - Prior period audited by different firm
  - Prior period figures not audited

## Reference to period

Corresponding figures	Comparative financial statements
<ul style="list-style-type: none"> <li>The auditor's report only refers to the current period unless there is an unresolved prior period modification</li> <li>For unresolved modifications the auditor would modify the current period opinion and explain the modification due to the effect of the unresolved matter on comparability of current period and prior period figures</li> </ul>	<ul style="list-style-type: none"> <li>The auditor's report refers to each period for which the financial statements are presented and for which an audit opinion is expressed</li> <li>If the opinion on the prior period included in the current year's financial statements differs from the opinion previously issued, this will need to be disclosed and explained in an 'other matter' paragraph</li> </ul>



## Restatement required?

Corresponding figures	Comparative financial statements
<p>The auditor will have to give a qualified or adverse opinion on the current period financial statement if there is a material misstatement in the corresponding figures for which:</p> <ol style="list-style-type: none"> <li>an unmodified opinion had been issued previously; and</li> <li>the corresponding figures have not been properly restated or disclosed</li> </ol>	<p>The auditor provides separate opinions on the current and prior periods so will need to restate the opinion on the prior period audit report and take steps to prevent future reliance on the auditor's previously issued report on the prior period financial statements</p>



## Prior period audited by different firm

Corresponding figures	Comparative financial statements
<p>As long as they are not prohibited from doing so by local regulations, the auditor would include an 'other matter' paragraph and explain the following:</p> <ol style="list-style-type: none"> <li>1. that the prior period financial statements were audited by a different firm;</li> <li>2. the nature of the opinion expressed by the predecessor auditor and if modified the reasons for modification;</li> <li>3. the date of the previous audit report</li> </ol>	<p>The auditor would include an 'other matter' paragraph within the current period auditor's report explaining:</p> <ol style="list-style-type: none"> <li>1. that the prior period financial statements were audited by a different firm;</li> <li>2. the nature of the opinion expressed by the predecessor auditor and if modified the reasons for modification;</li> <li>3. the date of the previous audit report</li> </ol>



## Prior period figures not audited

Corresponding figures	Comparative financial statements
<ul style="list-style-type: none"> <li>• The auditor would state in an 'other matter' paragraph that the corresponding figures are unaudited</li> </ul>	<ul style="list-style-type: none"> <li>• The auditor would state in an 'other matter' paragraph that the comparative financial information is unaudited</li> </ul>



## For your reference



Refer to Annex 7 for local guidance on corresponding figures



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## PART 7

# Audit Documentation



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## Audit Documentation

- **Key learning points:**

The various requirements associated with the documentation of audit planning, audit evidence obtained, and its ultimate storage

- **Relevant HKSAAs: HKSQC 1, 220, 230, 240, 300, 315, 330**



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## HKSQC 230.5

- **Objectives**

The objective of the auditor is to **prepare documentation** that provides:

- (a) A sufficient and appropriate record of the basis for the auditor's report; and
- (b) Evidence that the audit was planned and performed in accordance with HKSAAs and applicable legal and regulatory requirements



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## HKSQC 230.6

- For purposes of the HKSAs, the following terms have the meanings attributed below:
  - (a) **Audit documentation**—The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as “working papers” or “workpapers” are also sometimes used)
  - (b) **Audit file**—One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement
  - (c) **Experienced auditor**—An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:
    - (i) Audit processes;
    - (ii) HKSAs and applicable legal and regulatory requirements;
    - (iii) The business environment in which the entity operates; and
    - (iv) Auditing and financial reporting issues relevant to the entity’s industry



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## HKSQC 230.7

- The auditor shall prepare audit documentation on a timely basis (Ref: Para. A1)



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## Why is proper documentation so important ?

### Audit Documentation

Audit file documentation (whether maintained on paper or electronically) plays a critical role in:

✓ Assisting the engagement team in **planning** and **performing the audit**

✓ Providing **evidence** to demonstrate that the planned audit procedures were in fact performed

✓ Assisting engagement **reviewers** (including engagement quality control reviewers) in carrying out their responsibilities in accordance with professional standards

✓ Recording the **judgments involved** in forming the **audit opinion**

✓ Recording matters of **continuing significance** for **future audits** of the entity



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Good audit documentation is appropriately organized, and provides a record of the work done, the audit evidence obtained, the significant professional judgments applied, and the conclusions reached



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## CONSIDER POINTS

- ✓ **There is no need to provide documentation about HKSA requirements that are not relevant in the circumstances.** This would apply where the entire HKSA is not relevant (such as HKSA 610, when the entity has no internal audit function), or where the HKSA requirement is conditional and the condition does not exist
- ✓ **Audit documentation for smaller entities will generally be less extensive than for larger entities.** This particularly applies where:
  - The engagement partner performs all the audit work. Documentation would not include matters related to team discussions, allocation of responsibilities, or supervision; and
  - Some matters are so straightforward that they can be more conveniently addressed in a single document with cross-references to supporting working papers. This could include one or more of the areas such as the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality, assessed risks, significant matters noted, and the conclusions reached

## Specific documentation requirements under HKSA

- Many HKSA's contain specific documentation requirements that serve to clarify the requirements of HKSA 230. The following table provides a reference to the paragraphs in HKSA's that outline specific documentation requirements. This does not imply that there are no documentation requirements in the HKSA's that are not included in the list below.

ISA	Title	Paragraphs
210	Agreeing the Terms of Audit Engagements	10-12
220	Quality Control for an Audit of Financial Statements	24-25
230	Audit Documentation	All
240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements	44-47
250	Consideration of Laws and Regulations in an Audit of Financial Statements	29
260	Communication with Those Charged with Governance	23

## Specific documentation requirements under HKSA's (cont'd):

ISA	Title	Paragraphs
300	Planning an Audit of Financial Statements	12
315	Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment	32
320	Materiality in Planning and Performing an Audit	14
330	The Auditor's Responses to Assessed Risks	28-30
450	Evaluation of Misstatements Identified During the Audit	15
540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures	23
550	Related Parties	28
600	Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)	50
610	Using the Work of Internal Auditors	13



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## Audit File Organisation

- An area to be addressed by **firm-wide policies** is audit file organization and indexing
- Audit documentation is usually organized into logical divisions of work using an **indexing system**. If the file is electronic, the indexing can be in the form of folders and sub-folders. As each piece of audit documentation is created, it will be given a unique reference that ties directly into the overall file index

### Advantages of using a standard index, such as:

- Enables specific working papers to be easily located and shared among audit team members
- Facilitates file review by the various reviewers such as the manager, engagement partner, engagement quality control reviewer, and quality control monitors
- Provides consistency between audit files in the firm
- Assists with quality control functions such as checking for missing sign-off s, invalid cross-references, and unclear review notes



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## Examples of possible file indices:

Index by Audit Phase (extracts from an index)		Index by Financial Statement Area (extracts from an index)	
100-200	Financial statements and auditor's report	10	Financial statements and auditor's report
201-300	Tax returns, etc.	11	File completion memos, checklists, etc.
301-400	<b>File completion</b> such as memos on significant decisions, checklists and management representation letters	12	Overall audit strategy
401-500	<b>Audit planning</b> , including audit strategy and materiality	15	Materiality
501-600	<b>Risk assessment</b> , including understanding the entity and internal control	A	Cash
601-700	<b>Risk response</b> , including detailed audit plans by financial statement area	C	Receivables
701- 799	<b>Other</b> supporting documents such as trial balances and reports	D	Inventory
800	Financial reporting frameworks	BB	Payables
		DD	Long-term debt
		20	Revenues
		30	Purchases
		40	Payroll
		50	Taxation
		100	Subsequent events
		120	Contingencies
		150	Other supporting documents such as trial balances and reports



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## Audit Documentation

### Practical application – audit documentation

#### Common questions:

1. Who owns the Audit File?
2. Are copies of entity records examined required to be kept on the audit file?
3. Does each page of the audit file need to be initialled and dated by the preparer and then by the reviewer?
4. Should all considerations and use of professional judgments be documented?
5. Are preliminary drafts of financial statements required to be kept if materially inconsistent with the final financial statements?
6. Is it necessary to document non-compliance with HKSA requirements that are really not applicable to the audit?



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# Common Questions about Audit Documentation

## Who Owns the Audit File?

- Unless otherwise specified by legislation or regulation, audit documentation is the property of the audit firm



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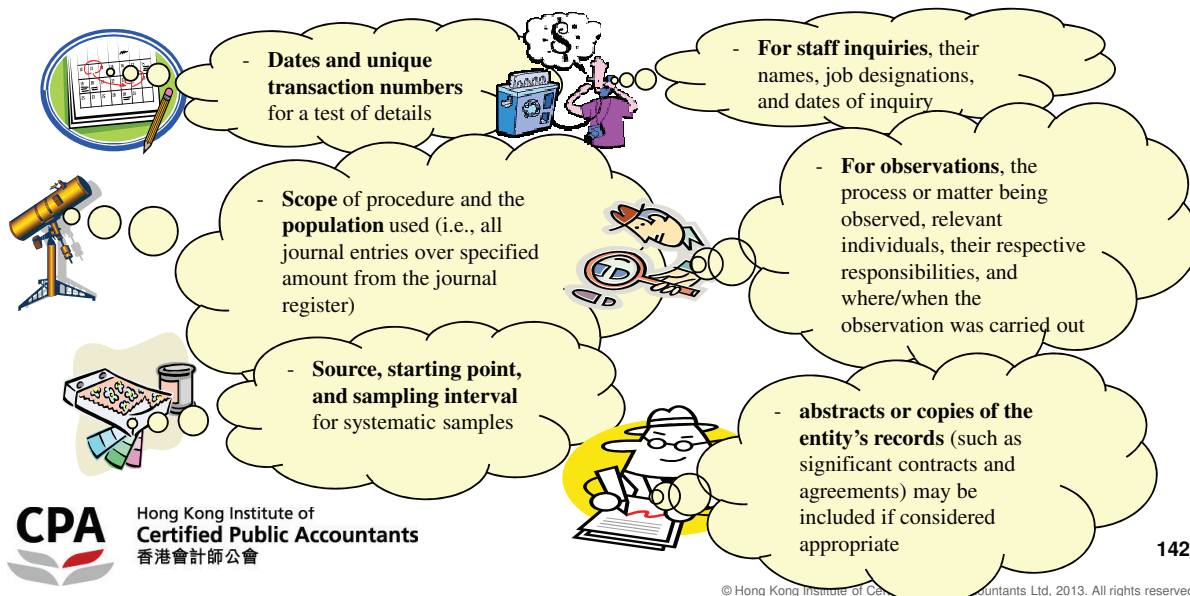
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# Common Questions about Audit Documentation

## Are copies of entity records examined required to be kept on the audit file?

- **No.** All that is required is some identifying characteristics of the transactions/ procedure being examined, so that the work could be replicated or exceptions investigated as necessary



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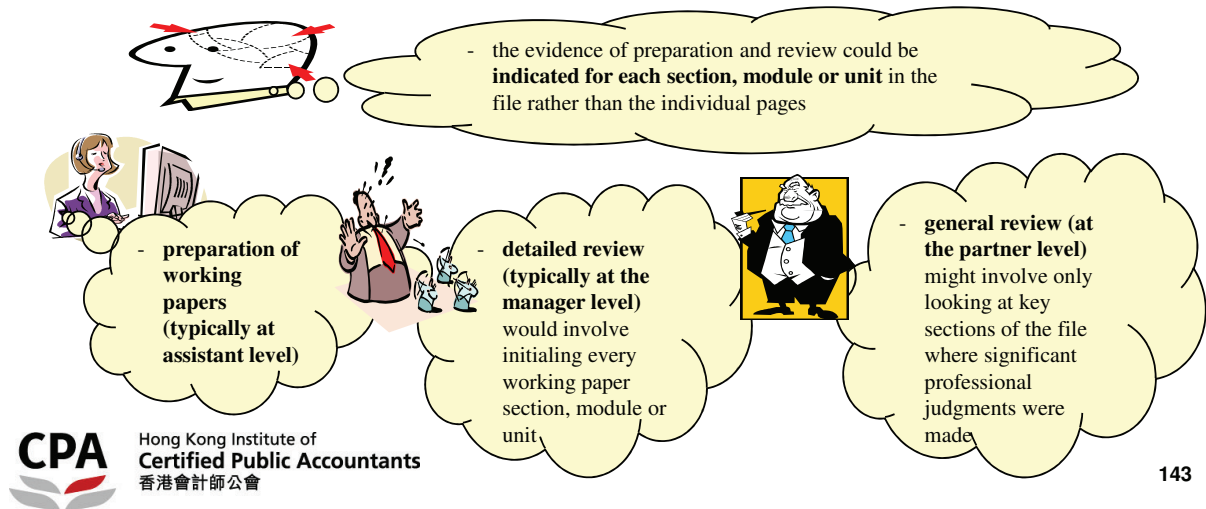
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# Common Questions about Audit Documentation

Does each page of the Audit File need to be initialled and dated by the preparer and then by the reviewer?

- **No.** The discipline of initialling working papers (as to who performed and who reviewed the audit work) has the effect of holding the engagement team accountable. However, this does not mean that each page of the working paper file needs to be initialled and dated



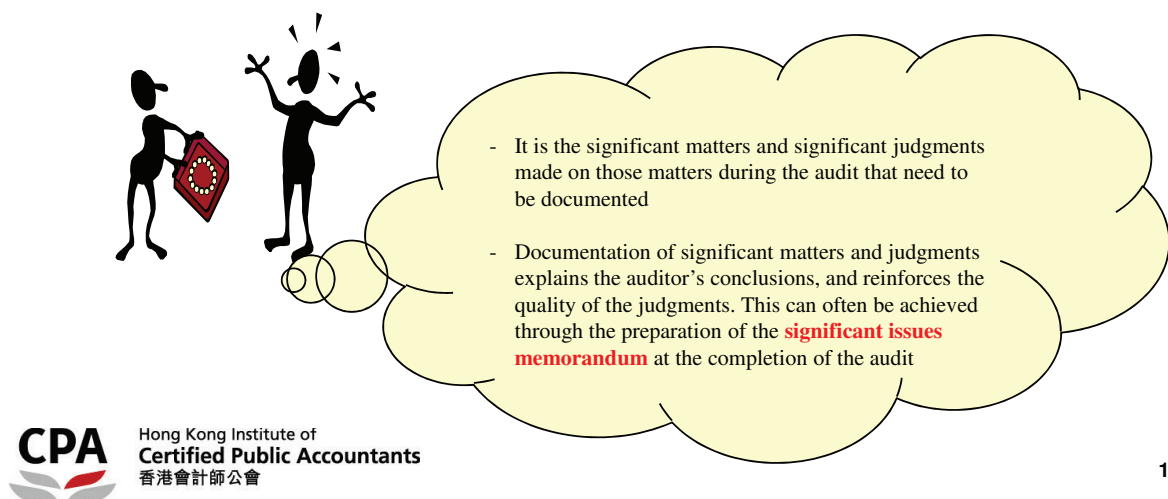
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# Common Questions about Audit Documentation

Should all considerations and use of professional judgments be documented?

- **No.** It is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made



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## Common Questions about Audit Documentation

Are preliminary drafts of financial statements required to be kept if materially inconsistent with the final financial statements?

- **No.** There is no requirement to retain documentation that was incorrect or superseded



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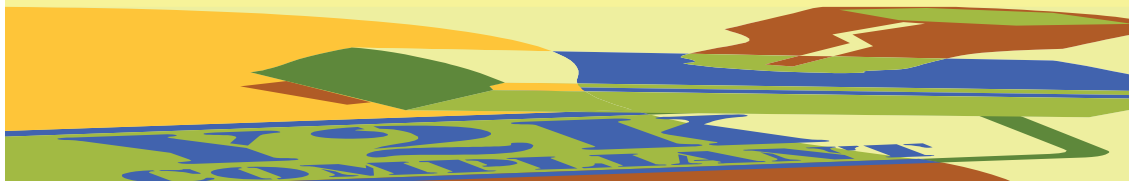
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## Common Questions about Audit Documentation

Is it necessary to document non-compliance with HKSA requirements that are really not applicable to the audit?

- **No.** Other than in exceptional circumstances, compliance is required with each HKSA requirement that is “relevant”
- An HKSA is clearly not relevant when the entire HKSA is not applicable, or when a HKSA requirement is conditional and the condition does not exist



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## Specific Documentation Requirements

### Risk Assessment

- The auditor shall include the following in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by HKSA 315:
    - (a) The **significant decisions reached** during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and
    - (b) The **identified and assessed risks** of material misstatement due to fraud at the financial statement level and at the assertion level
- [ Paragraph 240.44)



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## Specific Documentation Requirements

### Risk Assessment (cont'd)

- If the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to **revenue recognition** is not applicable in the circumstances of the engagement, the auditor shall **include in the audit documentation the reasons for that conclusion**
- [ Paragraph 240.47)
- The auditor shall include in the audit documentation:
    - (a) The **overall audit strategy**;
    - (b) The **audit plan**; and
    - (c) Any **significant changes** made during the audit engagement **to the overall audit strategy or the audit plan**, and the **reasons** for such changes. (Ref: Para. A16 – A19)
- [ Paragraph 300.12)



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# Specific Documentation Requirements

## Risk Assessment (cont'd)

- The auditor shall include in the audit documentation:
  - (a) The **discussion among the engagement team** where required by paragraph 10 and the significant decisions reached;
  - (b) **Key elements** of the **understanding** obtained regarding each of the aspects of the **entity and its environment** specified in paragraph 11 and of each of the **internal control components** specified in paragraphs 14-24; the **sources of information** from which the understanding was obtained; and the **risk assessment procedures performed**;
  - (c) The **identified and assessed risks** of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and
  - (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A144 – A147)

[ Paragraph 315.32]



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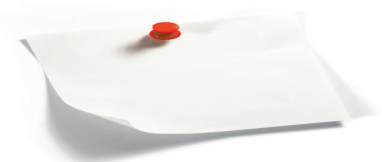
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## Typical audit documentation

### Risk Assessment Phase

- Pre-engagement (client acceptance) procedures
- Independence and ethics assessments
- Terms of engagement
- Materiality considerations
- Overall audit strategy
- Audit team discussions, including possible causes of material misstatement due to fraud
- Risk assessment procedures performed, and the results
- Assessed risks of material misstatement identified (at overall and assertion levels), based on the understanding of the entity obtained and related internal control (if any)
- Significant risks
- Communications with management and those charged with governance



**Remember to update risk assessment documentation for:**

- **Any new risks identified later in the audit; and**
- **Changes needed in risk assessments or materiality identified as a result of performing further audit procedures**



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## Specific Documentation Requirements

### Risk Response

- In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:
    - (a) The identifying characteristics of the **specific items or matters tested**; (Ref: Para. A12)
    - (b) **Who performed** the audit work and the **date such work was completed**; and
    - (c) **Who reviewed** the audit work performed and the **date and extent of such review** (Ref: Para. A13)
- [ Paragraph 230.9]



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## Specific Documentation Requirements

### Risk Response (cont'd)

- The auditor shall include the following in the audit documentation of the auditor's responses to the assessed risks of material misstatement required by HKSA 330:
    - (a) The **overall responses to the assessed risks of material misstatement due to fraud** at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and
    - (b) The **results of the audit procedures**, including those designed to address the risk of management override of controls.
- [Paragraph 240.45]



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## Specific Documentation Requirements

### Risk Response (cont'd)

- The auditor shall include in the audit documentation:
  - (a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing, and extent of the further audit procedures performed;
  - (b) The linkage of those procedures with the assessed risks at the assertion level; and
  - (c) The results of the audit procedures, including the conclusions where these are not otherwise clear (Ref: Para. A63)

[Paragraph 330.28]



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## Specific Documentation Requirements

### Risk Response (cont'd)

- The auditors' documentation shall demonstrate that the **financial statements agree or reconcile with the underlying accounting records**

[Paragraph 330.30]



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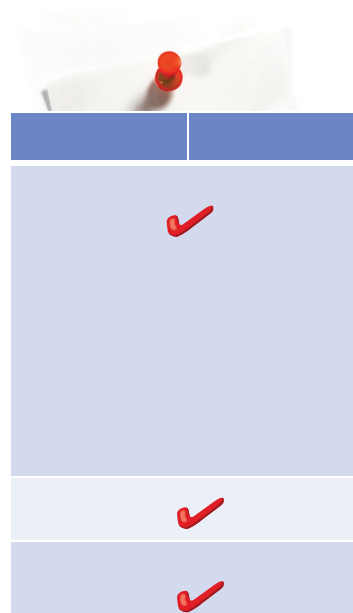
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## Typical audit documentation

### Risk Response Phase

1. An audit plan that addresses:
  - All material financial statement areas;
  - The assessed risks of material misstatement at the financial statement and assertion levels;
  - The nature, timing, and extent of the further audit procedures performed that respond to the assessed risks; and
  - Significant risks identified
2. Nature and extent of consultations with others
3. Significance and nature of the evidence obtained to the assertion being tested



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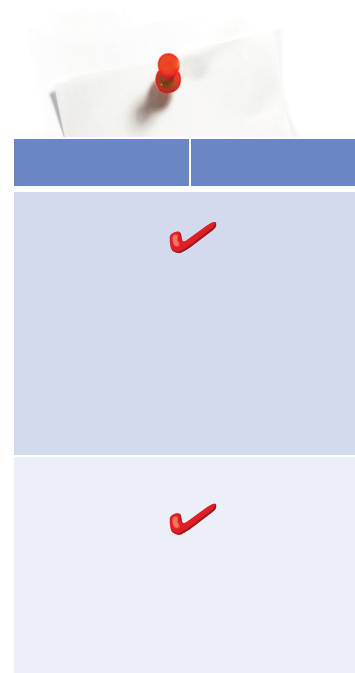
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## Typical audit documentation

### Risk Response Phase (cont'd)

4. A clear explanation of the results obtained from the test, and how any exceptions or deviations were followed up. This includes:
  - The basis for the test;
  - The choice of population;
  - The level of assessed risk; and
  - The sampling intervals and choice of the starting point.
5. Actions taken as a result of auditing procedures that indicate:
  - Need to modify planned auditing procedures;
  - Material misstatements may exist;
  - Omissions in the financial statements; or
  - The existence of significant deficiencies in internal control over financial reporting



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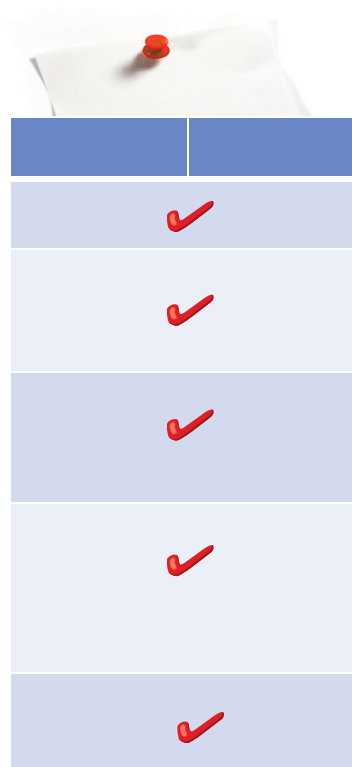
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## Typical audit documentation

### Risk Response Phase (cont'd)

6. Changes, if any, required to the overall audit strategy
7. Use of significant judgments applied on significant matters in performing work and evaluating results
8. Discussions with management on significant matters
9. Memoranda, analysis, details of assumptions used, and how the validity of the underlying information used was established
10. Cross-references to supporting documentation and evidence that the financial statements agree or reconcile with the underlying accounting records



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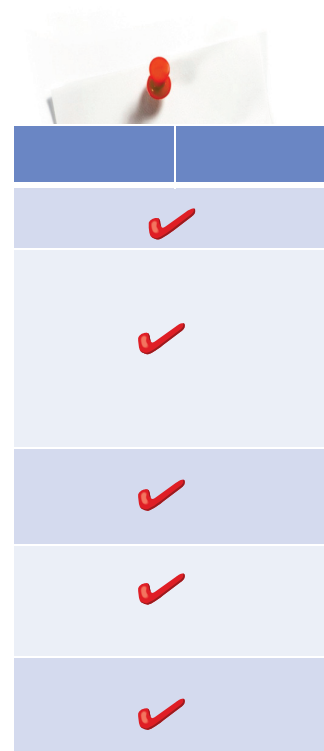
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## Typical audit documentation

### Reporting

- Completed audit programs
- Evidence of file reviews (that is, initials and checklists, etc.):
  - Detailed (manager/supervisor review),
  - Engagement partner review, and
  - Engagement quality control review, where applicable
- Information that is inconsistent with or contradicts the final conclusions
- Summary of financial effect of unadjusted errors identified, and management's response (i.e., adjustments made)
- Non-trivial uncorrected misstatements



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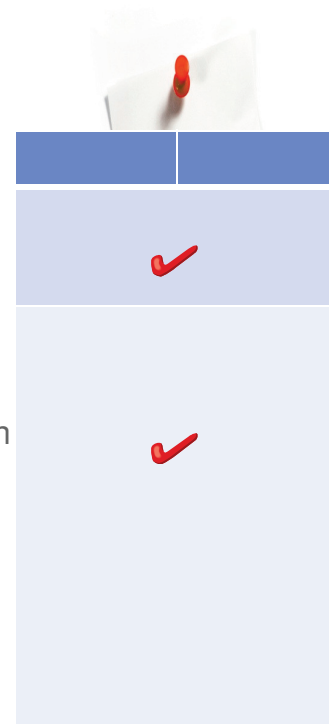
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## Typical audit documentation

### Reporting (cont'd)

- Significant matters arising:
  - Actions taken to address them (including additional evidence obtained), and
  - The basis for the conclusions reached
- If assistance was provided (where permissible under independence requirements) in preparing draft financial statements, describe the nature of discussions held with management to review the content of the statements. This would include:
  - Dates discussions were held,
  - Explanations provided on the application of complex accounting principles, and
  - Major questions raised by management



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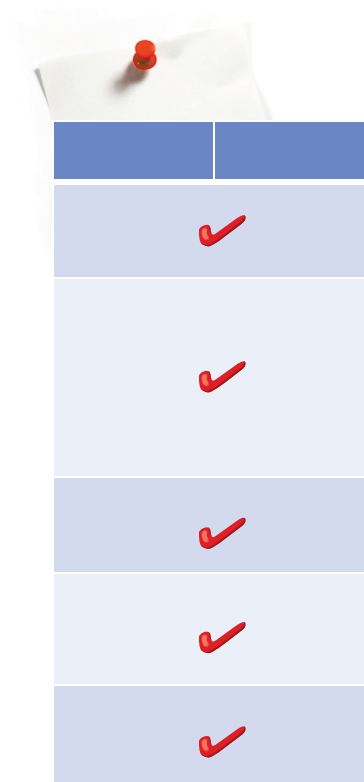
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## Typical audit documentation

### Reporting (cont'd)

- Copy of the financial statements and the auditor's report, cross-referenced to the audit file chapters
- Reasons for any departure from a relevant HKSA requirement, and the alternative procedures performed to achieve the aim of that requirement
- Any engagement-completion documents required by the firm
- Copy of all communication with management and those charged with governance
- Audit report date and the documentation completion date (see discussion on file completion)



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## The Experienced Auditor

- The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16-A17)
  - (a) The nature, timing and extent of the audit procedures performed to comply with the HKSAs and applicable legal and regulatory requirements; (Ref: Para. A6-A7)
  - (b) The results of the audit procedures performed, and the audit evidence obtained; and
  - (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions (Ref: Para. A8-A11)

[Paragraph 230.8]



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## Electronic Documents

- Many accounting firms have replaced (or are in the process of replacing) paper-based engagement files with electronic files. In some cases, even though the work was performed and reviewed electronically, paper files are maintained as the permanent record of work performed. Documents/forms are initiated in digital form, client records are scanned electronically, and all data is stored electronically. It is printed on paper only after all the work is completed and reviewed
- There are two types of electronic documents:
  - **Work-in-process**; and
  - **Static information**



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## Types of Electronic Documents

### Work-in-Process

- Work-in-process consists of dynamic information that is being developed and updated as the audit progresses
- Examples include blank audit forms and letter templates, industry knowledge and key performance indicators, questionnaires, logic trees, the firm's policies, diagnostics and the previous period's financial data, information, assumptions, etc. that may be used in performing this period's analytical procedures
- This information is often contained within software applications and electronic audit tools

### Static information

- Static information consists of final file documents, such as the financial statements and completed working papers, that will not change and may well be required for reference in future years
- Final or static documents must be retained in a format where the information can be retrieved easily in later years



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## Advantages of Automation

Maintaining audit files in an electronic form enables some administrative functions to be automated, and provides additional **flexibility** for engagement team members. For example:

- Specific working papers can be accessed directly from the index
- Files and documents can be easily shared or reviewed with others in distant locations
- New audit folders and documents can be created, renamed, moved, copied, or deleted from the index
- The detailed index can be collapsed to reveal its overall structure, or expanded as needed, making it easier to see the big picture and locate key documents
- Customized names can be given to important documents. This can help other team members to interpret the contents of a document from its name
- Review functions can be automated such as checking all or part of the audit file for exceptions, outstanding review notes, and preparer/reviewer sign-offs
- Engagement team members can share file documents by using electronic check-in and check-out tools
- Certain documents can be password-protected for enhanced security; and
- Access to files can be restricted to authorized personnel



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## Points to note when using electronic tools in working papers

Three important principles to note when using electronic tools in working-paper preparation:

- All the requirements of the HKSAs still apply
- Electronic files require electronic document management. This addresses matters such as **accessibility** (such as password access), **data security**, **application management** (including training), **back-up routines**, **edit rights**, **storage locations**, **review procedures**, and **decisions on what changes to files will be tracked to provide the necessary audit trail**
- Final documents (all documents that are required to be maintained to support the audit opinion) must be retained and be accessible in accordance with the firm's file retention policies



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## File completion



- The dating of the auditor's report signifies that the audit work is complete. After that date, there is no continuing responsibility to seek further audit evidence



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## File completion



- After the audit report date, the final assembly of audit files should take place on a timely basis. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report. (Refer to HKSQC 1 and HKSA 230 for more details)

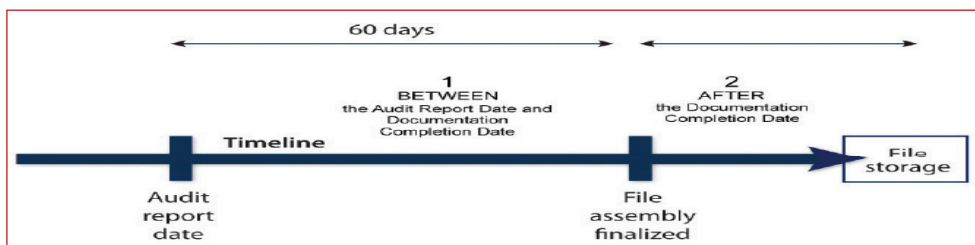
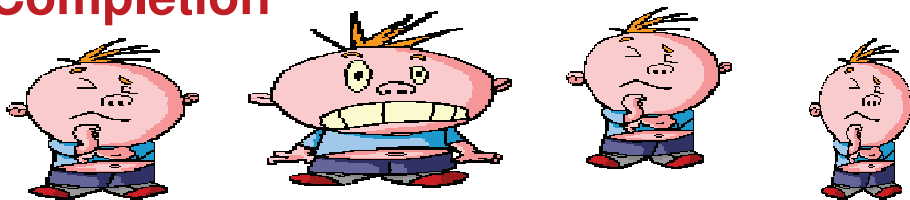


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## File Completion



- Making Changes to the Audit File. Can it be done ?**



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## Making Changes to the Audit File

- The requirements when making changes to audit file are as follows.

Period	Dates	Requirements
1	BETWEEN the Audit Report Date and Documentation Completion Date	<p><b>For administrative changes:</b></p> <ul style="list-style-type: none"><li>Document the nature of audit evidence obtained, who prepared and reviewed each document, and any additional memos to file that may be required;</li><li>Delete or discard superseded documentation;</li><li>Sort, collate, and cross-reference working papers; and</li><li>Sign off any completion checklists relating to the file assembly process.</li></ul> <p><b>For changes in the audit evidence or conclusions reached, additional documentation should be prepared that addresses three key questions:</b></p> <ul style="list-style-type: none"><li><b>When</b> and <b>by whom</b> such additions were made and (where applicable) reviewed;</li><li>The <b>specific reasons</b> for the additions; and</li><li>The <b>effect</b>, if any, of the additions on the audit conclusions</li></ul>

## Making Changes to the Audit File

Period	Dates	Requirements
2	AFTER the Documentation Completion Date	<p><b>NO documentation should be deleted</b> or discarded from the audit file until the firm's file retention period has expired</p> <p>Where it is necessary to make additions (including amendments) to audit documentation after the documentation completion date, the three key questions about changes in audit evidence, outlined in Period 1 above, should be answered, regardless of the nature of the additions</p>

## For your reference



Refer to Annex 8 for a checklist on documenting work performed

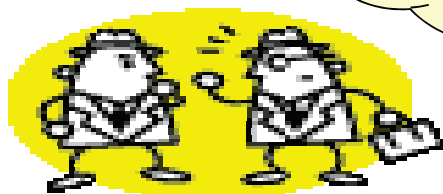


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## Audit Documentation



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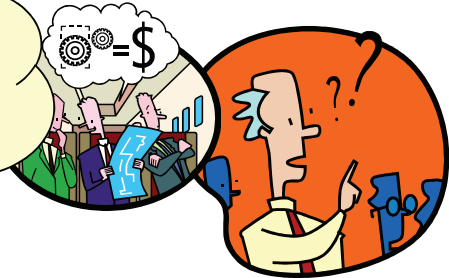
## Reporting



The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place (Ref: Para. A14)  
[ Paragraph 230.10]



If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency (Ref: Para. A15)  
[Paragraph 230.11]



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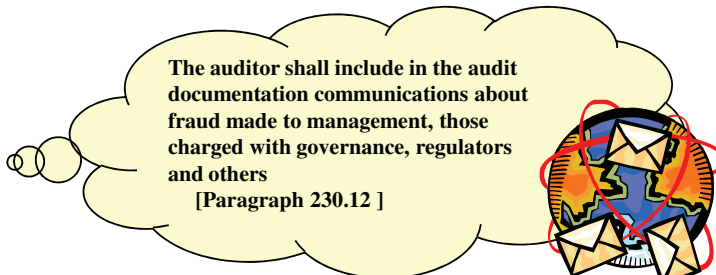
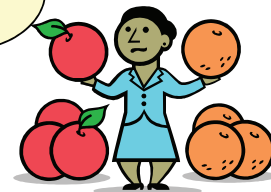
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## Reporting (cont'd)



If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in an HKSA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure (Ref: Para. A18-A19)  
[Paragraph 230.12 ]



The auditor shall include in the audit documentation communications about fraud made to management, those charged with governance, regulators and others  
[Paragraph 230.12 ]



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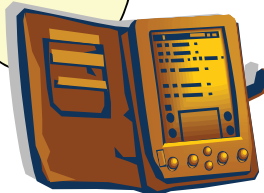
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## Electronic file



Leaving the information in a format used by a software application can be problematic if the software application is updated with a new file format. The old file may not be capable of being opened unless a copy of the old software application is also maintained. To overcome this problem, many firms are now saving their final file documents in a medium called **portable document format (PDF)**. PDF has been accepted and used by government agencies and accounting firms around the world. The firm's policies should state that final documents are not to be edited



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## Audit documentation

**Audit documentation  
should stand by itself and  
not need be supplemented  
by oral explanations**



Copies of client records inspected are not necessary on file, but some identifying characteristics(s), such as a number or date, etc., is required so that a person could re-perform the test if necessary

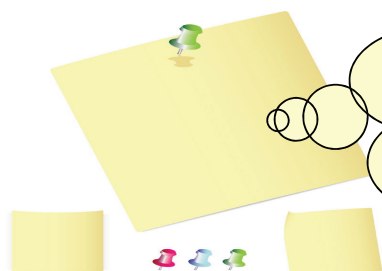


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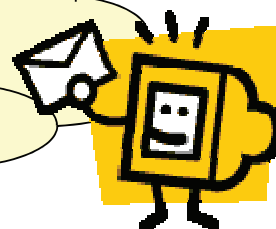
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## Audit Documentation



Take notes of verbal discussions with management on significant matters and record their responses. This will help to ensure that audit documentation contains the reasoning for all significant decisions made

Include copies of relevant emails or text messages exchanged with the client that address significant matters



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## The Experienced Auditor



The audit documentation should be such that an experienced auditor, who has had no previous connection with the audit, is able to understand (i.e., without the need for verbal explanations):

- The nature, timing, and extent of the audit procedures performed to comply with the applicable legal, regulatory and professional requirements;
- The results of the audit procedures and the audit evidence obtained; and
- The nature of significant matters arising and the conclusions reached



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# Thank you for your attention

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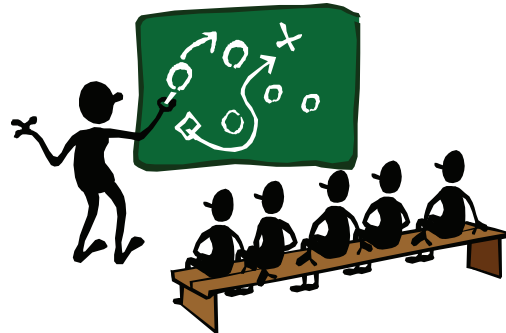
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Presented by : Winnie Chan, Associate Director, Technical Learning and Support, HKICPA  
Eky Liu, Manager, Technical Learning and Support, HKICPA  
Venue: The Hong Kong Institute of Certified Public Accountants

# ***A Refresher Course on Current Auditing Standards 2013 (Day 3)***



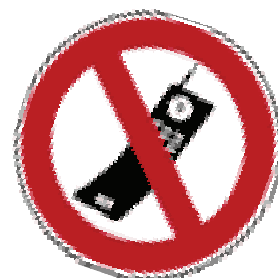
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## Agenda of today

1. Recap on audit procedures
2. Subsequent events and going concern
3. Use the work of an auditor's expert and/or internal auditors
4. Group audits
5. Physical inventory count
6. Initial engagement and comparatives
7. Audit documentation



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## **PART 3**

# **Using the work of an auditor's expert and internal auditors**



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# **Using the work of an auditor's expert**

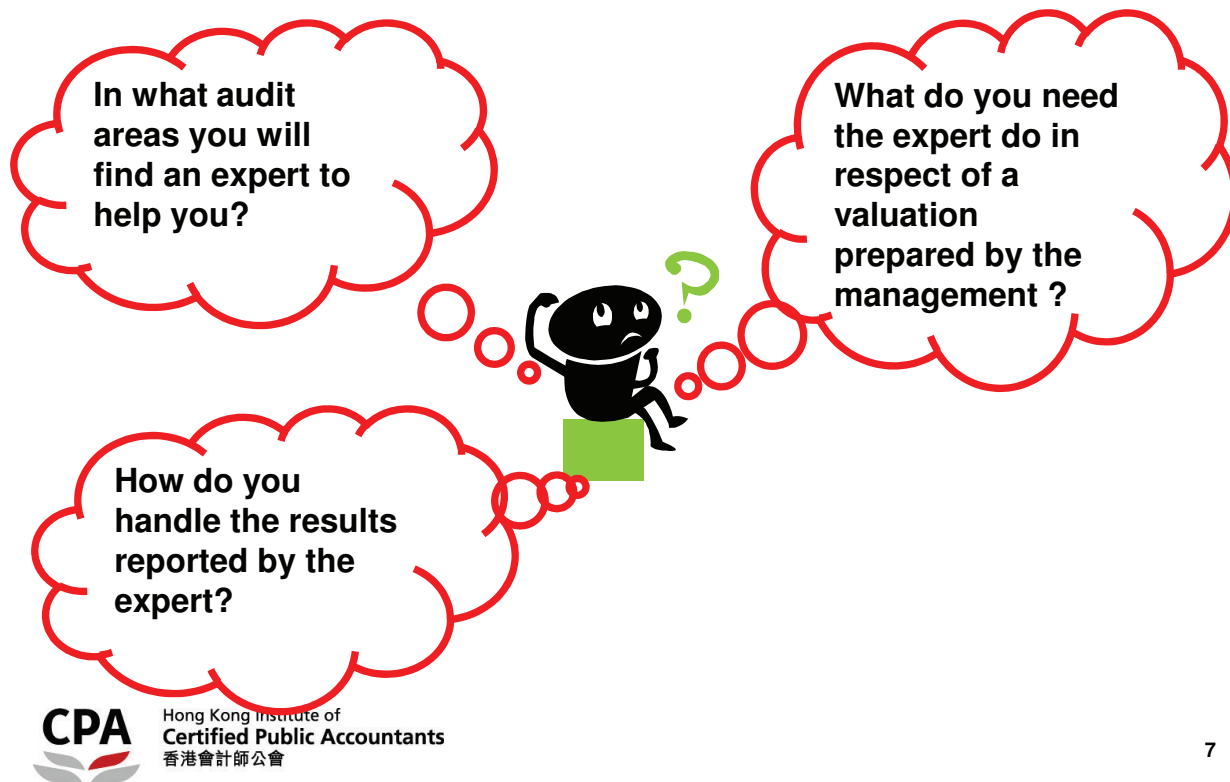


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## Using the work of an auditor's expert



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## Using the work of an auditor's expert

### Overview

- Auditors may engage internal or external experts to obtain sufficient appropriate evidence
- Applies HKSA 620 *"Using the work of an auditor's expert"*
- An auditor's expert – an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence

Examples of expertise that the auditor may require

- Specialized inventory counters;
- Valuations of assets such as land and buildings, plant and machinery, works of art, precious stones, inventory, and complex financial instruments;
- Determination of quantities or physical condition of assets such as minerals stored in stockpiles, underground mineral and petroleum reserves, and the remaining useful life of plant and machinery;
- Determination of amounts using specialized techniques or methods such as actuarial valuation;
- The analysis of complex or unusual tax-compliance issues;
- The measurement of work completed, and to be completed, on contracts in progress;
- Legal opinions concerning interpretations of agreements, statutes and regulations.

# Using the work of an auditor's expert

## Common issues:

- Practitioners merely obtained a copy of the valuation report as audit evidence without performing any evaluation
- Insufficient evidence of the competence, experience and objectivity of experts
- Insufficient evidence to indicate the detail of the work performed by the experts
- No follow-up performed by the auditors on the matters raised by the experts
- Practitioners argue that they did not possess the same expertise and knowledge and they were unable to challenge the expert's assumptions and methods used



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# Using the work of an auditor's expert

## Audit approach - overview

**Step 1: Determine need for auditor's expert**

**Step 2: Determine impact on audit procedures**

**Step 3: Evaluate expert's competence, capability and objectivity**

**Step 4: Obtain an understanding of the expert's field of expertise**

**Step 5: Agree terms**

**Step 6: Evaluate adequacy of the expert's work**



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# Using the work of an auditor's expert

## Audit approach – overview (cont'd)

### Step 1: Determine need for auditor's expert

In which of the following audit process does the auditor need expert?

- obtaining an understanding of the entity, including internal control;
- identifying/assessing the risks of material misstatement;
- determining/implementing overall responses to assessed risks at the financial statement level;
- designing/performing further audit procedures to respond to assessed risks at the assertion level; and
- evaluating the sufficiency/appropriateness of audit evidence obtained to form an opinion.



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# Using the work of an auditor's expert

## Audit approach – overview (cont'd)

### Step 2: Determine impact on audit procedures

Consider:

- the nature of the matter for which the expert is required and the risks of material misstatement;
- the significance of the expert's work in the context of the audit;
- previous work (if any) performed by that expert; and
- whether the expert is subject to the audit firm's quality control policies and procedures.



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# Using the work of an auditor's expert

## Audit approach – overview (cont'd)

### Step 3: Evaluate expert's competence, capability and objectivity

**Competence** – nature and level of expertise

**Capability** – ability to exercise that competence in the circumstances of the engagement (e.g. geographic location and the time and resources.)

**Objectivity** – possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgement



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# Using the work of an auditor's expert

## Audit approach – overview (cont'd)

### Step 3: Evaluate expert's competence, capability and objectivity (cont'd)



How can the auditor evaluate the expert's competence, capability and objectivity?



Discussion with the expert / other auditors who have worked with him/her



Qualification, membership of profession body, license to practice



External recognition, published books or papers, market news



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# Using the work of an auditor's expert

## Audit approach – overview (cont'd)

### Step 4: Obtain an understanding of the expert's field of expertise

Is there sufficient understanding of the auditor's expert's field of work to:

- plan the audit; and
- review the results of work performed?

### Step 5: Agree terms



The written agreement should address:

- Nature, scope, and objectives of expert's work;
- Respective roles and responsibilities;
- Nature, timing, and extent of communication, including the report format; and
- Need for confidentiality.

Refer to [Annex 2](#) for lists matters that the auditor may consider for inclusion in such an engagement letter



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# Using the work of an auditor's expert

## Audit approach – overview (cont'd)

### Step 5: Agree terms (cont'd)

In establishing the terms of engagement, consider factors such as the following:

- access of the auditor's expert to sensitive or confidential entity information;
- the respective roles or responsibilities of the auditor and the auditor's expert;
- any multi-jurisdictional, legal, or regulatory requirements;
- the complexity of the work required;
- previous experience by the auditor's expert with the entity; and
- the extent of the auditor's expert's work, and its significance in the context of the audit.



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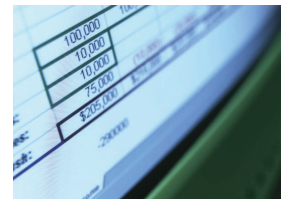
# Using the work of an auditor's expert

## Audit approach - overview (cont'd)

### Step 6: Evaluate adequacy of the expert's work

This would include:

- **relevance and reasonableness of expert's findings or conclusions;**
- if expert's work involves significant assumptions and methods the relevance and reasonableness of those assumptions and methods in the circumstances;
- if expert's work involves use of source data significant to the experts work, the relevance, completeness and accuracy of that source data.



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# Using the work of an auditor's expert

## Audit approach - overview (cont'd)

### Step 6: Evaluate adequacy of the expert's work (cont'd)

If the results of the expert's work are unsatisfactory or inconsistent with other evidence, the auditor should resolve the matter. This may involve:

- Discussions with the entity and the expert;
- Applying additional audit procedures;
- Possibly engaging another expert; or
- Modifying the auditor's report.



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# Using the work of an auditor's expert

## Reporting

The auditor shall not refer to the work of an auditor's expert in an auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the auditor shall indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the auditor's opinion.

If the auditor makes reference to the work of an auditor's expert in the auditor's report because such reference is relevant to an understanding of a modification to the auditor's opinion, the auditor shall indicate in the auditor's report that such reference does not reduce the auditor's responsibility for that opinion.



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# Using the work of Internal auditors



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# Using the work of internal auditors

## Overview

In larger entities and public organisations, an internal audit department is often established to monitor the effectiveness of various aspects of internal control which could include:

- monitoring of internal controls;
- examination of financial and operating information
- reviewing operating activities;
- review of compliance with law and regulations;
- risk management and governance.

**HKSA 610 (Revised 2013) *Using the work of internal auditors*** deals with the external auditor's responsibilities if using the work of internal auditors. This includes:

- a) Using the work of the internal audit function in obtaining audit evidence
- b) Using internal auditors to provide direct assistance under the direction, supervision and review of the external auditors



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# Using the work of internal auditors

## When is Internal Audit's work relevant?

Where the objectives and scope of internal audit work includes a review of internal controls over financial reporting, the external auditor may wish to use the work of the internal auditor and modify the nature and extent of their own audit procedures.

However, as internal audit are employed by the entity and are not independent from it, the external auditor cannot rely on their work to the same degree as that performed by their own external audit team.

For this reason, before external auditors can rely on relevant work performed by internal audit they must:

- determine **whether to, and to what extent to use specific work of the internal auditors;**
- if using the work of internal auditors to **determine if it is adequate for the purpose of the audit.**



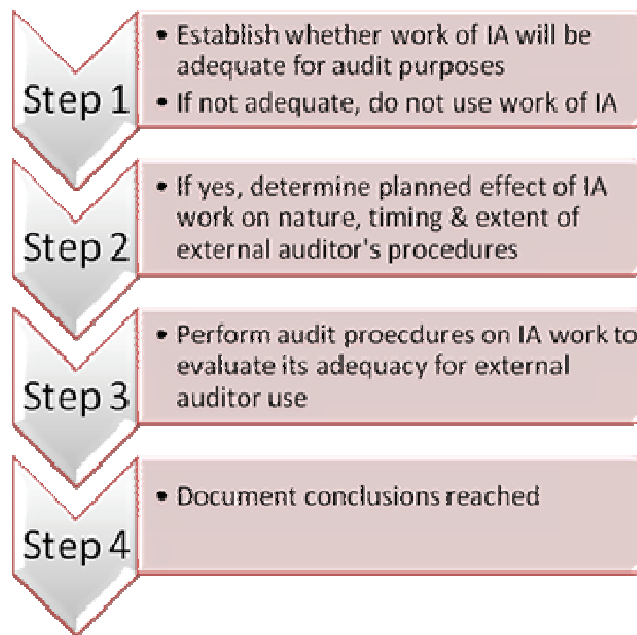
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# Using the work of internal auditors

## The Process



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# Using the work of internal auditors

## Step 1

Evaluate the internal audit function

Determine:

- what are the **objectives and scope** of the internal audit function?
- how objective (independent) is the internal audit function?
- are the internal auditors technically competent?
- Whether the internal audit function applies a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities?



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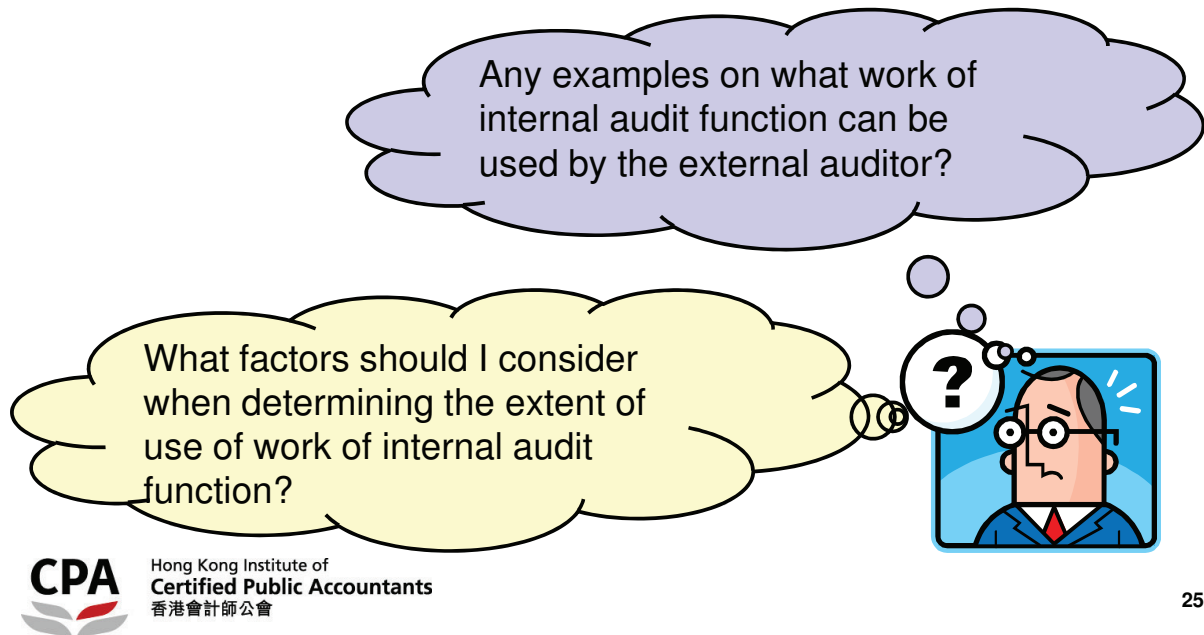
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## Using the work of internal auditors

### Step 2

Determine the **nature and extent of work** of the Internal Audit Function that can be used



## Using the work of internal auditors

### Step 2 (cont'd)

The following work of internal audit function can be used by the external auditor:

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



# Using the work of internal auditors

## Step 2 (cont'd)

The nature and extent of work of internal audit function that can be used / external auditor's audit procedures are responsive to the evaluation of :

- the amount of judgement involved in planning and performing audit procedures and evaluating the audit evidence
- The assessed risk of material misstatement
- The internal audit function's organizational status and relevant policies and procedures supporting the objectivity of the internal auditors
- The level of competence of the internal audit function

The external auditor has to **communicate with TCWG** an overview of the planned scope and timing of the audit in accordance with HKSA 260, including **how to use the work of internal audit function**.



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# Using the work of internal auditors

## Step 3

Discuss the planned use of their work with the internal audit function as a basis for coordinating the respective activities, in particular, in respect of the following items:

- **timing** of work;
- **Nature** of work performed;
- **extent** of audit coverage;
- **materiality** for financial statements as a whole and performance materiality;
- proposed methods of **item selection** and **sample size**;
- **documentation** of work performed; and
- **review and reporting** processes.



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## Using the work of internal auditors

### Step 3 (cont'd)

Determine the adequacy of specific work performed by internal auditors. Evaluate:

- did the internal auditors performing the work have **adequate technical training and proficiency**?
- was the work properly **supervised, reviewed, and documented**?
- was adequate audit evidence obtained to enable the internal auditors to **draw reasonable conclusions**?
- were the conclusions reached appropriate in the circumstances?
- were any **reports** prepared by the internal auditors consistent with the results of the work performed?
- were **any exceptions or unusual matters** disclosed by the internal auditors properly resolved?



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## Using the work of internal auditors

### Step 3 (cont'd)

When the external auditors need to assess the adequacy of the work of internal auditors for the purposes of the audit, the external auditors could perform procedures such as:

- **Making inquiries of appropriate individuals** within the internal audit function
- **observation of procedures** performed by internal audit function
- **Reviewing** the internal audit function's **work program and working papers**
- **Re-performance**, including:
  - ✓ **examination of items** already examined by the internal auditors;
  - ✓ examination of other **similar items**;



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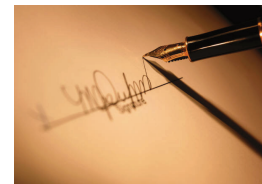
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# Using the work of internal auditors

## Step 4

If the external auditor uses the specific work of the internal auditors, the external auditor must include in the audit documentation:

- **evaluation** of the adequacy of internal auditor's work;
- **Nature and extent of work used** and the basis for that decision; and
- **description of audit procedures** performed by the external auditor to evaluate the adequacy of the work used



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# Using the work of internal auditors

## Reporting

Remember the external auditor has sole responsibility for the audit opinion expressed and this is not reduced by using the work of the internal auditor. Therefore the audit report cannot contain reference to the work of the internal auditors.



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# Using the work of internal auditors

## Using Internal auditors to provide direct assistance

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

Effective date - for audits of financial statements for periods ending on or after 15 December 2014



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# Using the work of internal auditors

## Using Internal auditors to provide direct assistance

Apart from the previous procedures, what **additional audit procedures** does the auditor need to do?

1. Evaluate the **existence and significance of threats to objectivity** and the level of competence
2. Obtain written agreement that the IA will **follow the external auditor's instructions** and the entity will not intervene in the work the IA perform
3. Obtain written agreement that IA will **keep confidential** specific matters as instructed by the external auditor



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# Using the work of internal auditors

## Using Internal auditors to provide direct assistance

4. **Direct, supervise and review** the work performed by the IA in accordance with HKSA 220, generally be of a different nature and more extensive
5. **Check back to the underlying audit evidence** for some of the work performed by IA

### Additional documentation

- evaluation of objectivity
- basis of decision for the nature and extent of IA work
- Who review the work performed and the date and extent of review
- written agreements on points 2 and 3 above
- working file prepared by the IA



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## PART 4

# Group audits



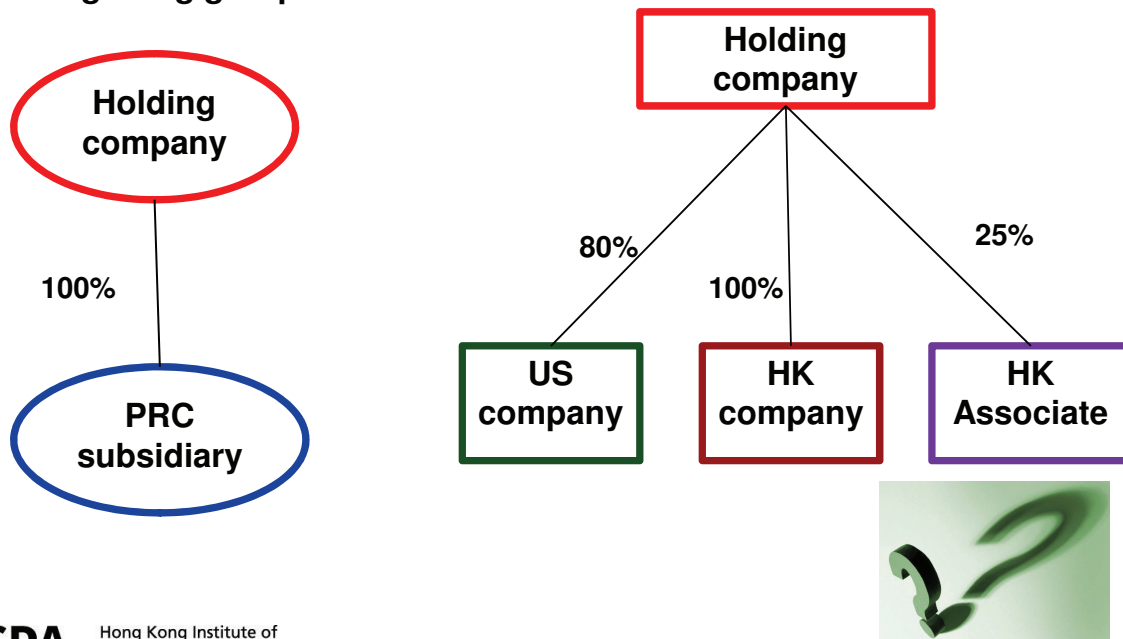
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## Group audits

What audit procedures would you do in the audit of the following Hong Kong groups?



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## Group audits

### Overview

- Applies HKSA 600 Special considerations – audits of group financial statements (including the work of component auditors)
- It outlines responsibilities, communications and requirements for and between the:
  - ✓ Group engagement partners, group engagement teams; and
  - ✓ Component auditors who perform work (such as auditing a division, branch, or subsidiary of the group) on behalf of the group engagement team and then report on the results.
- The requirements outlined may also be useful for other situations where an auditor involves another auditor in some part of the audit of financial statements, e.g. observation of inventory count or performing specific procedures at a remote location.



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# Group audits

## Objectives of HKSA 600

- To determine **whether to act as the auditor of the group** financial statements; and
- If acting as the auditor of the group financial statements:
  - (i) To communicate clearly with component auditors about the **scope and timing** of their work on financial information related to components and their findings; and
  - (ii) To obtain **sufficient appropriate audit evidence** regarding the **financial information of the components and the consolidation process** to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.



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# Group audits

## Definitions



Component	<ul style="list-style-type: none"><li>• An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements.</li><li>• Depends on the financial reporting structure of the group:<ul style="list-style-type: none"><li>✓ Organisational structure – parent, subsidiaries, joint ventures; head office, divisions, branches</li><li>✓ By function, process, product, service or geographical locations</li></ul></li></ul>
Component auditor	<ul style="list-style-type: none"><li>• An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit.</li><li>• It refers to a different firm or different audit team / office from the same firm participated in the audit.</li></ul>
Component management	Management responsible for preparing the financial information of a component.
Component materiality	The materiality for a component determined by the group engagement team.



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# Group audits

## Definitions (cont'd)

Group	All the components whose financial information is included in the group financial statements. A group always has more than one component.
Group financial statements	Financial statements that include the financial information of more than one component. It also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.
Group engagement team	Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.



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# Group audits

## Responsibility

- The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements.
- The auditor's report on the group financial statements shall not refer to a component auditor.

### Modified group audit opinion

When the group audit opinion is modified because the group engagement team was **unable to obtain sufficient appropriate audit evidence in relation to the financial information of one or more components**, the **Basis for Modification paragraph** in the auditor's report on the group financial statements describes **the reasons for that inability without referring to the component auditor**, unless such a reference is necessary for an adequate explanation of the circumstances.



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# Group audits

## Acceptance /continuance and planning

1. The group engagement team shall obtain **an understanding of the group, its components, and their environments** that is sufficient to identify components that are likely to be significant components.

### What are significant components?

- (a) **Individual financially significant** to the group

According to HKSA 600.A5, a component should normally be regarded as significant if **a chosen benchmark exceed 15%** of the group figure.

.Gross assets /Liabilities

.Cash flows

.Profits

.Turnover

If a higher or lower percentage or a different benchmark is deemed more appropriate, then this should be explained.

- (b) it is likely to **include significant risks** of financial misstatement of the group financial statements due to its nature or the specific circumstances that apply.

Again, it requires the exercise of **professional judgement!!!**

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# Group audits

## Acceptance /continuance and planning (cont'd)

2. Where component auditors will perform work on the financial information of such components, the group engagement partner shall **evaluate whether the group engagement team will be able to be involved in the work of those component auditors** to the extent necessary to obtain sufficient appropriate audit evidence.

What does the group engagement team need to understand about the group in relation to step 1 & 2?

O.O.O.

# Group audits

## Acceptance /continuance and planning (cont'd)

### Examples:

- **Group structure** (that is, how the group financial reporting system is organized)
- **Components' business activities that are significant to the group**
- **Use of service organizations**, including shared service centers
- A description of **group-wide controls**, i.e. controls designed, implemented and maintained by the group management over group financial reporting
- The **complexity of the consolidation process**.
- Whether component auditors that are not from the group engagement partner's firm or network will perform work on the financial information of any of the components, and group management's rationale for appointing more than one auditor.
- Whether the group engagement team:
  - ✓ Will have **unrestricted access** to TCWG of the group, group management, TCWG of the component, component management, component information, and the component auditors (including relevant audit); and
  - ✓ Will be **able to perform necessary work** on the financial information of the components.

# Group audits

## Acceptance /continuance and planning (cont'd)

If the group engagement partner concludes that:

- (a) it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence due to restrictions imposed by group management; and
- (b) the possible effect of this inability will result in a disclaimer of opinion on the group financial statements



The group engagement partner shall either:

- (a) in the case of a new engagement, **not accept the engagement**, or, in the case of a continuing engagement, **withdraw from the engagement**, where withdrawal is possible under applicable law or regulation; or
- (b) where law or regulation prohibits an auditor from declining an engagement or where withdrawal from an engagement is not otherwise possible, having performed the audit of the group financial statements to the extent possible, **disclaim an opinion on the group financial statements**.

Refer to **Annex 3** for an example of qualified opinion based on the group management team's inability to obtain sufficient appropriate audit evidence in relation to a significant component

## Group audits

### Acceptance /continuance and planning (cont'd)

2. The group engagement partner shall agree on the terms of the group audit engagement in accordance with HKSA 210.

Additional matters may be included in the terms of a group audit:

- **Communication between the group auditor and the component auditors** should be **unrestricted** to the extent possible under law or regulation
- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on significant deficiencies in internal control, should be communicated as well to the group engagement team;
- The group auditor should be permitted:
  - ✓ **Access to component information**, those charged with governance of components, component management, and the component auditors (including relevant audit documentation sought by the group engagement team); and
  - ✓ **To perform work or request a component auditor to perform work** on the financial information of the components



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## Group audits

### Acceptance /continuance and planning (cont'd)

3. The group engagement team shall establish an overall group audit strategy, and shall develop a group audit plan in accordance with HKSA 300.



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## Group audits

### Understanding the Group, its components and their environment

The group engagement team shall obtain an understanding that is sufficient to:

- Confirm or revise its initial identification of **components that are likely to be significant**; and
- **Assess the risks of material misstatement** of the group financial statements, whether **due to fraud or error**.

What are the matters that the group engagement team need to understand?

- Group-wide controls
- Consolidation procedures
- Instruction issued by group management to components
- Group management's assessment of risks of material misstatements due to fraud
- Group management's and /or TCWG's process for identifying, responding to risk of fraud and the controls established to mitigate these risks
- Whether TCWG, group management, internal audit have knowledge of any actual, suspected, or alleged fraud affecting a component or the group

Refer to [Annex 3](#) for examples of matters relating to group-wide controls and consolidation procedures.

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## Group audits

### Understanding the Group, its components and their environment (cont'd)

What are the possible **fraud risk factors** for a group financial statements?

- Complex group structure / transactions
- Poor corporate governance structures
- Non-existent or ineffective group-wide controls
- Prior occurrences of unauthorised or incomplete consolidation adjustments
- Aggressive tax planning within the group
- Components with different financial year-ends, which may be utilized to manipulate the timing of transactions

Refer to [Annex 3](#) further examples.

Remember apart from the understanding obtained from the group engagement team, it is necessary to **discuss with component auditors and group management** for risk assessment.

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# Group audits

## Understanding the component auditor

If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of:

- Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent;
- The component auditor's professional competence;
- Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence; and
- Whether the component auditor operates in a regulatory environment that actively oversees auditors.



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# Group audits

## Understanding the component auditor (cont'd)

### How to deal with the following situations?

Less than serious concern over (i) the professional competency or; (ii) the component auditor does not operate in an environment that actively oversees auditors	Group engagement team: <ul style="list-style-type: none"><li>actively involved in the work of the component auditor</li><li>performing additional risk assessment or further audit procedures on the component's financial information</li></ul>
•Serious concern over (i) or (ii) •Independence issue	Group engagement team shall obtain sufficient appropriate audit evidence by performing work on the financial information of that component themselves
Law or regulation prohibit access to audit documentation of component auditor	Request the component auditor to prepare a memorandum for reporting



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# Group audits

## Understanding the component auditor (cont'd)

### First year of involving a component auditor



- Evaluate the results of the quality control monitoring system where the group engagement team and component auditor are from a firm or network that operates under and complies with common monitoring policies and procedures;
- Visit the component auditor to discuss the matters in (a)-(c);
- Request the component auditor to confirm the matters referred to in (a)-(c) in writing.
- Request the component auditor to complete questionnaires about the matters in (a)-(c);
- Discuss the component auditor with colleagues in the group engagement partner's firm, or with a reputable third party that has knowledge of the component auditor; or
- Obtain confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties.



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# Group audits

## Materiality

The group engagement team shall determine:

- Materiality for the group financial statements as a whole when establishing the overall group audit strategy;
- Lower amounts than group materiality, where applicable, for particular classes of transactions, account balances, or disclosures;
- Performance materiality for the group
- Component materiality for those components (and performance materiality) where component auditors will perform an audit or a review for purposes of the group audit; and
- The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.



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# Group audits

## Materiality (cont'd)

### Component materiality

- Used by the component auditor to evaluate whether uncorrected misstatements are material, individually or in the aggregate.
- It is set lower than materiality for the group financial statement as a whole
- Different components will have different component materiality
- It need not be an arithmetical portion of the materiality for the group financial statements as a whole
- Aggregate of component materiality for different components may exceed the materiality for the group financial statements as a whole

### Component performance materiality

- If determine by the component auditor, group auditor need to evaluate its appropriateness
- In practice, group auditor may set such materiality for the component auditors.



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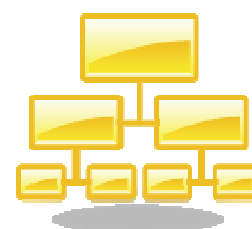
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# Group audits

## Responding to assessed risks

The group engagement team's determination of the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor is affected by:

- The **significance** of the component;
- The **identified significant risks** of material misstatement of the group financial statements;
- The group engagement team's **evaluation of the design of group-wide controls** and determination whether they have been **implemented**; and
- The group engagement team's **understanding of the component auditor**.



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## Group audits

### Responding to assessed risks (cont'd)

Financially significant	Significant risk due to specific nature or circumstances	Not significant
Full audit using component materiality	Full audit using component materiality  OR Audit of one or more balances, classes of transaction or disclosures relating to those significant risks  OR Specific audit procedures relating to those significant risks	Analytical procedures at group level.



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## Group audits

### Responding to assessed risks (cont'd)

If there is **no sufficient appropriate audit evidence** obtained from:

- (a) the work performed on the financial information of significant components;
- (b) the work performed on group-wide controls and the consolidation process;
- and
- (c) the analytical procedures performed at group level,

Select not significant components and perform, or request a component auditor to perform, one or more of the following on the financial information of the individual components selected:

- An audit of the financial information of the component using component materiality.
- An audit of one or more account balances, classes of transactions or disclosures.
- A review of the financial information of the component using component materiality.
- Specified procedures.

The group engagement team shall vary the selection of components over a period of time.



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# Group audits

## Involvement in the work performed by component auditor

For **significant components** audited by component auditors, the group auditor shall also:

- (a) Discuss with the component auditor or component management those of the component's **business activities that are significant** to the group;
- (b) Discuss with the component auditor the **susceptibility of the component** to material misstatement of the financial information due to **fraud or error**; and
- (c) **Review the component auditor's documentation** of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the **identified significant risks**.
- (d) Evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements and determine whether it is necessary to be **involved in the further audit procedures**.



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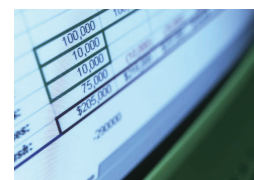
# Group audits

## Consolidation process

- tests the **operating effectiveness of group-wide controls**
- evaluating whether **all components have been included in the group financial statements**.
- evaluate the **appropriateness, completeness and accuracy of consolidation adjustments and reclassifications**, and shall evaluate whether any fraud risk factors or indicators of possible **management bias** exist
- evaluate whether the financial information of that component has been appropriately adjusted for if **different accounting policy** is used
- determine whether the financial information identified in the component auditor's communication is the financial information that is incorporated in the group financial statements.
- evaluate whether appropriate adjustments have been made to the financial statements with **different year end** in accordance with the applicable financial reporting framework.



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# Group audits

## Subsequent events

The group engagement team or the component auditors shall perform procedures designed to identify subsequent events that may require adjustment to or disclosure in the group financial statements.

The group engagement team shall request the component auditors to notify the group engagement team if they become aware of subsequent events.



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# Group audits

## Communication with the component auditor



The group engagement team shall communicate its requirements to the component auditor on a timely basis. This communication shall set out the work to be performed, the use to be made of that work, and the form and content of the component auditor's communication with the group engagement team. This would include:

### Group auditor → component auditor

- Confirmation that the component auditor will cooperate with the group engagement team;
- Relevant ethical and independence requirements;
- Component materiality;
- Identified significant risks of material misstatement of the group financial statements, due to fraud or error, and that are relevant to the work of the component auditor; and
- A list of related parties prepared by group management, and the timely communication of related parties not previously identified by group management or the group engagement team

Refer to [Annex 3](#) for matters to be included in the letter of instruction.



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## Group audits



### Communication with the component auditor (cont'd)

#### Component auditor → Group auditor

- Compliance by component auditor with:
  - **Ethical requirements** including independence and professional competence, and
  - The group engagement team's requirements;
- What financial information of the component is being reported upon;
- Instances of non-compliance with laws or regulations;
- **A list of uncorrected misstatements**;
- Indicators of **possible management bias**;
- Any **identified significant deficiencies in internal control** at the component level;
- Other **significant matters** that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud;
- Any other matters that may be relevant to the group audit, including exceptions noted in the written representations that the component auditor requested from component management; and
- The component auditor's **overall findings, conclusions, or opinion**.



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## Group audits

### Communication with the component auditor (cont'd)

#### Additional Local Guidance on Communication with the Component Auditor

1. In Hong Kong where, if a holding company and its subsidiary are incorporated in Hong Kong, section 133(1)(a) of the Companies Ordinance imposes a duty on the subsidiary and its auditors to give to the auditors of the holding company such information and explanation as those auditors may reasonably require for the purposes of their duties as auditors of the holding company.
2. Where a holding company is incorporated in Hong Kong, but its subsidiary is not, section 133(1)(b) of the Companies Ordinance imposes a duty on the holding company, if required by its auditors to do so, to take all such steps as are reasonably open to it to obtain from the subsidiary such information and explanation as the group engagement team may reasonably require for the purpose of their duty as the group engagement team.



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## Group audits

### Evaluating the sufficiency and appropriateness of audit evidence

The group engagement team shall:

- Discuss significant matters arising from the evaluation of evidence with the component auditor, component management, or group management, as appropriate; and
- Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation.

- If the work of the component auditor is insufficient → determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team
- Evaluate the effect of any uncorrected misstatements on the group audit opinion, and any instances where there has been an inability to obtain sufficient appropriate audit evidence



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## Group audits

### Communication with group management and TCWG

The group engagement team shall communicate the following matters:

- An overview of the type of work to be performed on the financial information of the components;
- An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components;
- Instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work;
- Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted; and
- Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls, or others where the fraud resulted in a material misstatement of the group financial statements.



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# Group audits

## Documentation

The group engagement team shall include in the audit documentation the following matters:

- An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components; Refer to Annex 4 for an example on the documentation.
- The nature, timing, and extent of the group engagement team's involvement in the work performed by the component auditors on significant components, including, where applicable, the group engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon; and
- Written communications between the group engagement team and the component auditors about the group engagement team's requirements.



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# Group audits

**What are the common issues / problems you have encountered when you act as a group auditor?**



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## Group audits



### Common issues identified – What would you do?

- **Restrictions on involvement** of group auditors in the work of component auditors, such as their risk assessment process
- Inability to **gain access to component audit files**
- **Component auditors not responding to instructions** issued by the group auditor
- Group auditors did not assess component auditors' **independence and competence** before placing reliance on component auditors' work (including when the component auditor is a member firm of the group auditor's network in other jurisdiction)
- **No analysis of components** in the group to determine those that are significant, and the type of work that should be performed on the financial information of the components

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## Group audits



### Common issues identified – What would you do? (Cont'd)

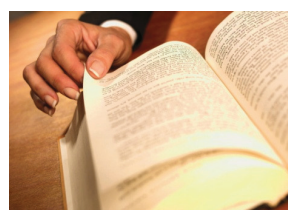
- Insufficient justification of the **scoping and materiality** established for component audit procedures
- Insufficient evidence to show that group auditors had considered the **appropriateness of work** performed by component auditors
- Group auditors failed to **follow up on potential audit issues** identified by component auditors in their reporting deliverables
- Insufficient documentation / **evidence of review of working papers** of component auditors (including network firms)
- Insufficient **evidence of review of the reporting pack** submitted by the component auditor and any **subsequent correspondence**

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# Group audits

## Relevant links

- [http://www.hkicpa.org.hk/file/media/section6\\_standards/technical\\_resources/pdf-file/financialauditing/2013/alert17.pdf](http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/financialauditing/2013/alert17.pdf)
- [http://www.hkicpa.org.hk/file/media/section6\\_standards/technical\\_resources/pdf-file/financialauditing/2013/alert18.pdf](http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/financialauditing/2013/alert18.pdf)



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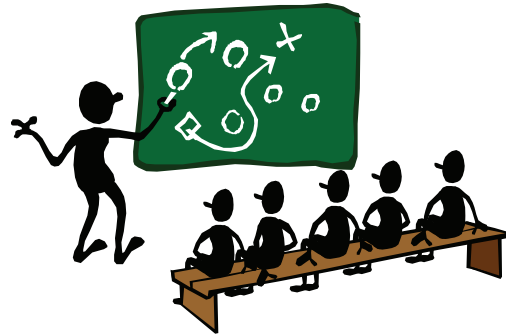
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## **A Refresher Course on Current Auditing Standards**

### **Day 4**

<b>Time</b>	<b>Topic</b>
8:30 - 9:00	Registration
9:00 - 9:30	Recap on audit procedures and audit evidence
9:30 - 10:15	Evaluating audit evidence
10:15 - 10:45	Management letter
10:45 - 11:00	Break
11:00 - 11:45	Communication with those charged with governance
11:45 - 12:45	Audit opinion and qualification
12:45 - 13:45	Lunch
13:45 - 14:30	Quality control in general
14:30 - 15:30	Engagement performance
15:30 - 15:45	Break
15:45 - 16:30	Monitoring
16:30 - 17:00	Recap on audit completion and quality control

# ***A Refresher Course on Current Auditing Standards 2013 (Day 4)***



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## **Agenda of today**

- 1. Recap on audit procedures and audit evidence**
- 2. Evaluating audit evidence**
- 3. Representation letter**
- 4. Communication with those charged with governance**
- 5. Audit opinion and qualification**
- 6. Quality control in general**
- 7. Engagement performance**
- 8. Monitoring**
- 9. Recap on audit completion and quality control**



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# PART 1

## Recap on audit procedures and audit evidence



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## Recap on audit procedures and audit evidence

### Questions

1. Which TWO of the following are 'subsequent events' as defined by the relevant HKSA?
  - a. Facts becoming known to the auditor after the date of the auditor's report
  - b. Events occurring between the date of the financial statements and the date of the auditor's report
  - c. Facts becoming known to the entity after the date of the financial statements
  - d. Events occurring after the date of the auditor's report



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## Recap on audit procedures and audit evidence

### Questions

2. A manufacturing company prepares financial statements to 31 December 20X1. On 28 February 20X2, before the audit is complete, a large truck carrying toxic chemicals crashes whilst leaving the factory, causing a dangerous spillage which may have environmental implications for the local area. Which TWO of the following statements are TRUE?
- a. The event which happened after the year end may require disclosure in the financial statements at 31 December 20X1 due to the potential for a legal claim in relation to the environmental damage
  - b. The event which happened after the year end does not provide evidence of conditions that existed at the date of the financial statements and so can be ignored by the auditor
  - c. The auditor should design audit procedures to ascertain whether the financial statements need amendment for the subsequent event
  - d. The auditor has no obligation to perform any further audit procedures in relation to this matter



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## Recap on audit procedures and audit evidence

### Questions

3. Which ONE of the following is true?

If management has prepared an assessment of the entity's ability to continue as a going concern then the auditor will check that it covers a period of:

- a. At least 12 months from the date of the auditor's report
- b. At least 12 months from the date of the financial statements
- c. The foreseeable future
- d. At least 12 months from the date the financial statements are issued



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## Recap on audit procedures and audit evidence

### Questions

4. Both management and the auditors agree that the going concern assumption is appropriate but material uncertainty exists in relation to the ability to continue as a going concern. Management have disclosed this properly in the financial statements. What implications would this have for the audit opinion?
- a. Adverse opinion
  - b. Unmodified opinion with emphasis of matter paragraph
  - c. Unmodified opinion only
  - d. Disclaimer of opinion



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## Recap on audit procedures and audit evidence

### Questions

5. Which of the following statements about using the work of an auditor's expert are CORRECT under HKSA 620?
- a. An auditor's expert may be either an internal expert or an external expert.
  - b. An auditor's expert refers to an individual or organization possessing expertise in the accounting and auditing field.
  - c. The auditor should evaluate the competence, capability and objectivity of the auditor's expert.
  - d. The audit report must not refer to the work of an auditor's expert, but can refer to the work of a management's expert.



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## Recap on audit procedures and audit evidence

### Questions

6. Are the following statements about group audits true or false?

#### Statement 1

If a component has a risk which is likely to be included as a significant risk of financial statement of the group financial statement, that component is a significant component to the group.

#### Statement 2

If the profit for the year of the component exceed 15% of the group figure, that component must be classified as a significant component.



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## Recap on audit procedures and audit evidence

### Questions

7. Which of the following statements about group audits are CORRECT under HKSA 600 Special considerations – audits of group financial statements (including the work of component auditors)?

- a. A component auditor who at the request of the service organisation provides an assurance report on the controls of a service organization.
- b. The determination of the components depends on the financial reporting structure of the group. A component can be a function, process, product or service.
- c. The group engagement team needs to determine the component materiality for all the components that are under audit or review by the component auditors.
- d. For all significant components, a full audit using component materiality must be performed by the component auditors.



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## Recap on audit procedures and audit evidence

### Questions

8. Which of the following statements about audit documentation are correct?
- a. An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.
  - b. Under normal circumstances, between the auditor's report date and the documentation completion date, auditors are only allowed to amend the audit file for administrative purpose.
  - c. Auditors can remove the duplicated working papers from the audit file after the documentation completion date.



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## Recap on audit procedures and audit evidence

### Questions

9. Which of the following bank confirmations are considered to have reliability doubts?
- a. The auditor receives the bank confirmations directly.
  - b. The envelope of the confirmation has been opened before the auditor receives it.
  - c. The confirming party returns back the confirmation via fax.
  - d. There is no signature by the confirmation party on the returned confirmation.



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## Recap on audit procedures and audit evidence

### Questions

10. Are the following statements about external confirmation true or false?

#### Statement 1

An auditor can rely on a fax copy of bank confirmation as an audit evidence.

#### Statement 2

Alternative procedures should be performed when there are no responses from the confirming parties.



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## Recap on audit procedures

### Questions

11. Are the following statements true or false?

#### Statement 1

Corresponding figures are amounts and other disclosures included as an integral part of the current period financial statements.

#### Statement 2

When corresponding figures are included the auditor's report refers to each period (current and prior) separately.



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## Recap on audit procedures

### Questions

12. Which TWO of the following statements are TRUE if corresponding figures have not been audited?

- a. The auditor should state that the corresponding figures are unaudited in an 'emphasis of matter paragraph'
- b. The auditor should state that the corresponding figures are unaudited in an 'other matter' paragraph
- c. The auditor should audit the corresponding figures
- d. The auditor should obtain sufficient appropriate audit evidence that the opening figures don't contain material misstatements that affect the current period



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## PART 2

# Evaluating audit evidence



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## Evaluating audit evidence



**What's next after all the planned audit procedures have been performed ?**



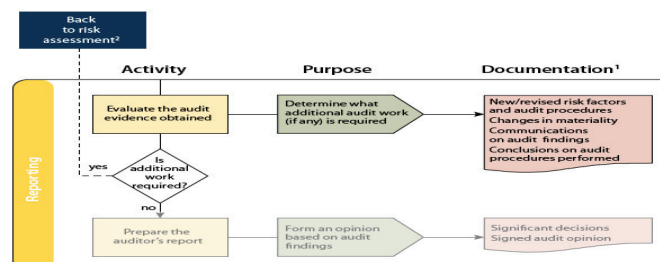
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## Overview

- After the planned audit procedures have been performed, the auditor must evaluate the results including a **review** of:
  - ❖ **audit documentation**;
  - ❖ **discussions with engagement team**; and
  - ❖ any **changes to the audit plan** required as a result of procedures performed
- This evaluation should help the auditor decide whether **sufficient appropriate audit evidence** has been obtained to support the conclusions reached and for an appropriate audit opinion to be reached



Notes:  
1. Refer to ISA 230 for a more complete list of documentation required.  
2. Planning (ISA 300) is a continual and iterative process throughout the audit.



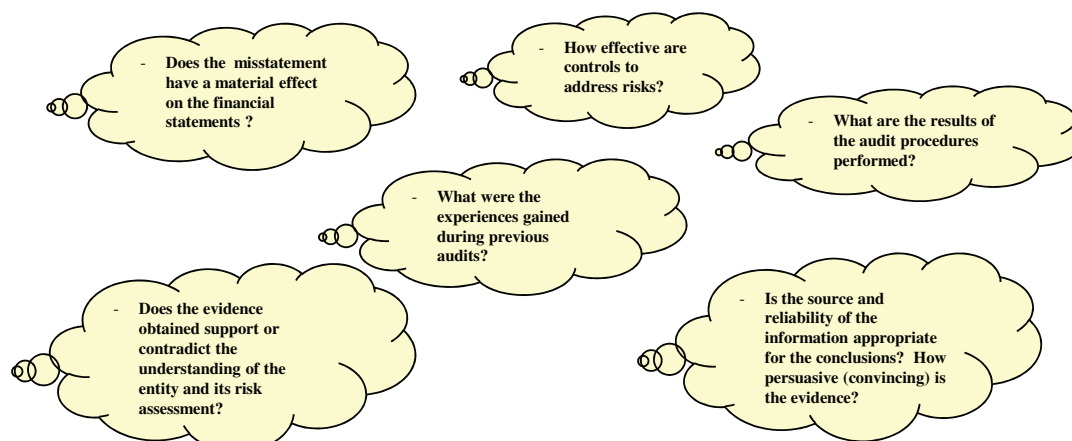
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## How does the auditor decide whether evidence gathered is sufficient appropriate audit evidence?

- **HKSA330** *The auditor's responses to assessed risks* suggests that this will be dependent on **auditor's judgement**, which could be influenced by various factors

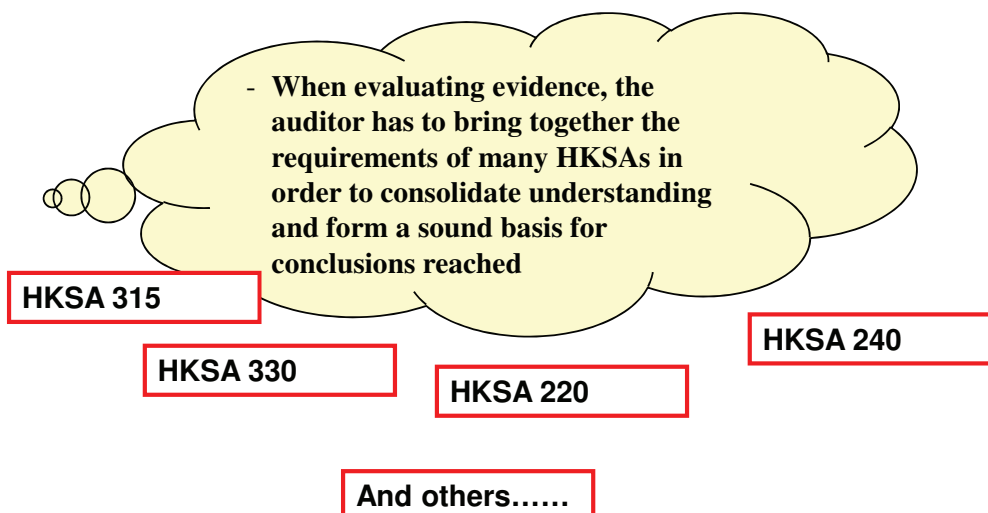


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## How does the auditor decide whether evidence gathered is sufficient appropriate audit evidence?



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## Scenario example: evaluating audit evidence

### Scenario

- ABC Ltd is a Hong Kong listed company engaged in selling long-haul luxury travel packages with a financial year ended September 30, 2013
- ABC Ltd has been audited by CEF & Co for a number of years. For subsequent event review and as a result of the legal file review, the auditor discovered letter received from the legal advisor dated November, 2013 about a class action against ABC Ltd in respect of ABC's negligence and a serious breach of health and safety regulations leading to a fire that broke out in a theatre which resulted in serious injuries to ABC's customers who were attending a show as part of their holiday package organised by ABC Ltd.
- The families of the injured believe ABC was negligent due to its failure to carry out a proper risk assessment or any health and safety checks on the theatre before selecting it as a venue for customers on its holiday package
- The Hong Kong Travel Consumer Association (HKTCA) is seeking compensation on behalf of the injured families as part of a class action against ABC Ltd
- Correspondence between management of ABC Ltd and the legal representative of HKTCA provide further details of the status of the class action (please refer to Annex 1 for the preliminary findings)



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ISSUES ???

ADDITIONAL  
AUDIT  
STEPS???

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## How should the auditor evaluate evidence ?

The auditors should evaluate the audit evidence obtained by:

- |                     |  |
|---------------------|--|
| ▪ HKAS 320          | ▪ Reassessing materiality  |
| ▪ HKSA315, HKSA 240 | ▪ Considering changes in risk assessment including potential increased risk of misstatement due to fraud |
| ▪ HKSA 450          | ▪ Evaluating the effect of misstatements   |
| ▪ HKSA 330          | ▪ Considering the sufficiency and appropriateness of the evidence valuating the effect of misstatements  |
| ▪ HKSA 520          | ▪ Applying final analytical procedures   |



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# Reassessing materiality

## Why may an auditor change the materiality?

- ❖ Initial materiality levels are not appropriate in the context of actual financial results eg, **different from planned**
- ❖ **New information** comes to light that would have caused the auditor to calculate a different amount e.g., a decision to dispose of the business
- ❖ There are **unexpected misstatements** that cause materiality to be exceeded for particular classes of transactions, balances or disclosures

## Point to note:

**If materiality has to be revised, do not wait until the end of the audit to make the change. If materiality is lowered, it may well require changes in risk assessments and the performance of additional or further audit procedures**



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# Reassessing materiality(Cont'd)

- ❖ Remember the **initial determination of materiality** is often based on **estimates** of the entity's financial results and the **actual** results may be **different**
- ❖ For this reason **HKSA 450 Evaluating misstatements identified during audit** requires that the auditor should **reassess** the amounts which were calculated for **overall and performance materiality** **before** the auditor **evaluates** the **results** of the audit procedures performed and any **misstatement** that arose from them
- ❖ If a **revision** is required then the auditor will need to consider and **document** the **impact** on assessed risks and the nature, timing and extent of any further audit procedures. If **materiality becomes lower** the auditor may well need to **perform additional or further audit procedures**



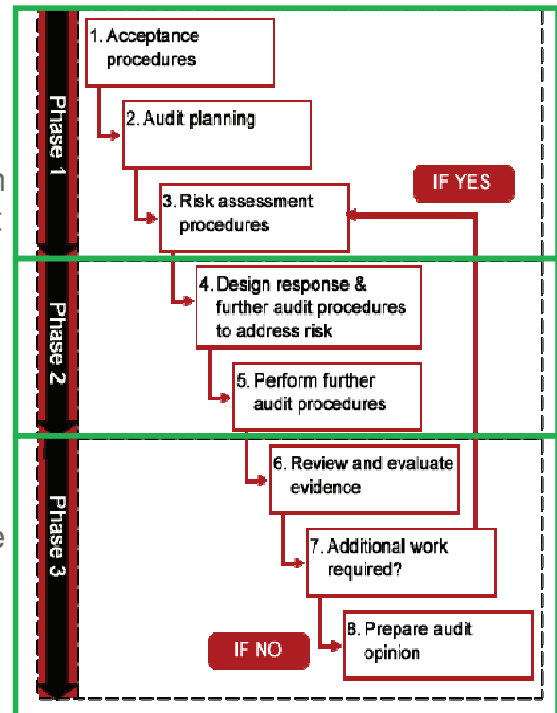
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## Considering changes in risk assessments

- ❖ The auditor assesses risks at the assertion level (in phase 1), based on the knowledge obtained before performing further auditor procedures (in phase 2). Practically though, whilst audit procedures are being performed, new information may come to light that requires modification of the original risk assessment. For this reason **HKSA 330** *The auditor's response to risk* requires the auditor to evaluate whether the assessed risks of material misstatement at the assertion level are still appropriate **before** concluding the audit and forming an opinion



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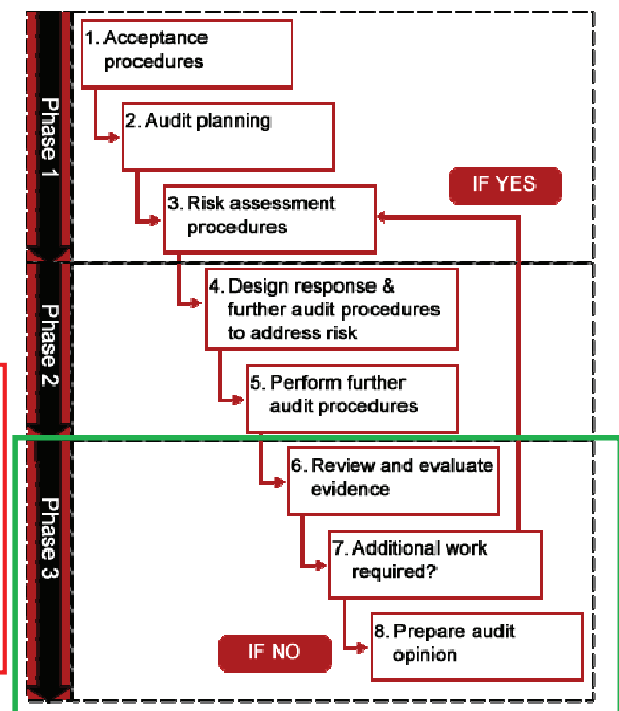
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## Considering changes in risk assessments (Cont'd)

- If the auditor believes there to be a change in risk, **HKSA 315** *Identifying and assessing the risks of material misstatement*, requires that the risk assessment be revised which may mean further audit procedures

### Points to note:

- ❖ Auditors must perform further procedures to reflect changes in risk
- ❖ Details also need to be documented including how the audit plan has been changed to address the revised risk assessment



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# What could cause the auditor to change the assessment of risk?

Types of matters that may cause the auditor to change their original assessment of risk and therefore decide to perform more audit procedures:

## Internal control

### - Tests of controls

Do the results of performing tests of controls support the planned level of risk reduction based on their operating effectiveness?

### - Management override

Is there any evidence of management override of existing internal control?

### - Control deficiencies

Does a potential misstatement(s) result from a deficiency in internal control that should be immediately brought to management's attention?



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# What could cause the auditor to change the assessment of risk? (Cont'd)

## Nature of audit evidence obtained

### - New risk factors

Does the evidence identify any new business risks, fraud risk factors, or management override?

### - Contradictory evidence

Does the evidence obtained contradict other sources of information available?

### - Conflicting evidence

Does the evidence obtained conflict with the current understanding of the entity?

### - Accounting policies

Is there evidence that the entity's accounting policies are not always consistently applied?



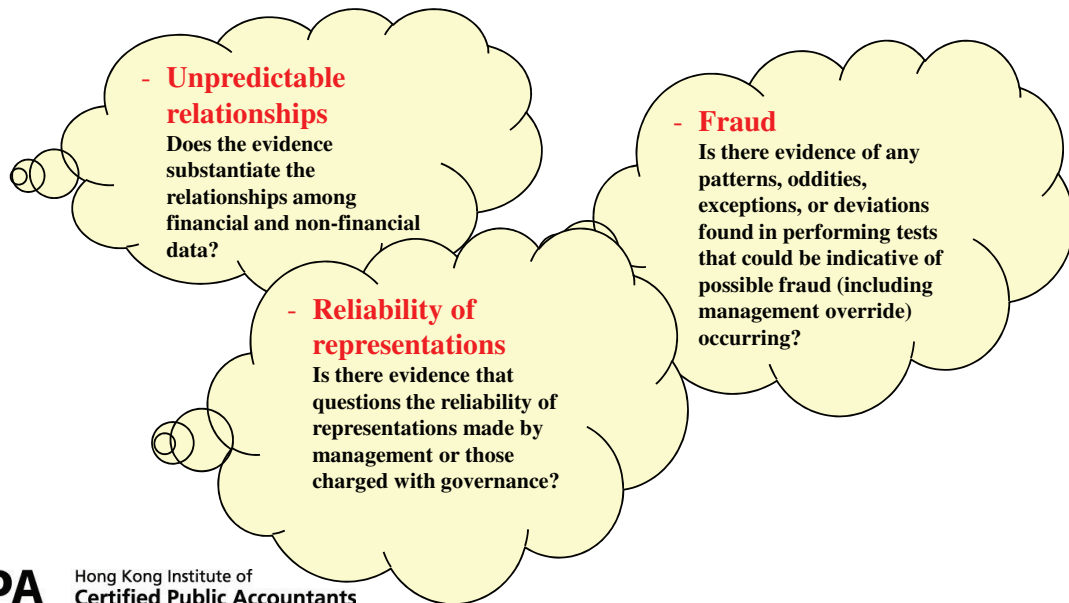
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## What could cause the auditor to change the assessment of risk? (Cont'd)

### Nature of audit evidence obtained (Con't)



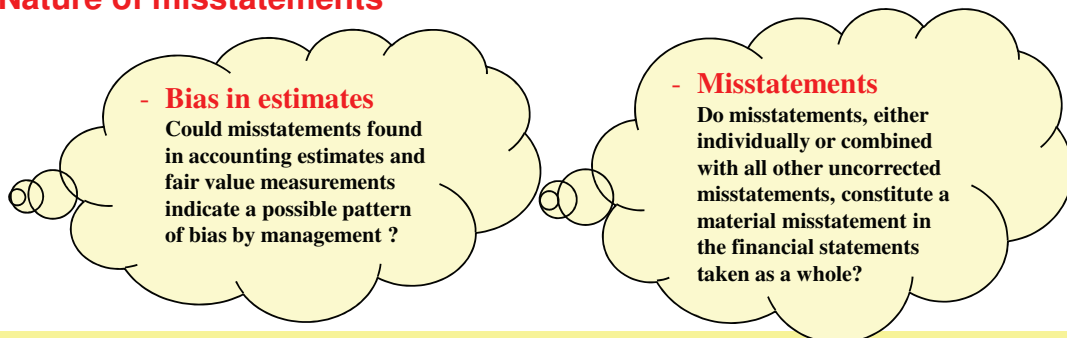
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## What could cause the auditor to change the assessment of risk? (Cont'd)

### Nature of misstatements



### Point to note:

Allocate time in the audit budget for the audit engagement team to discuss their findings (as a group) immediately after the work is completed. The matters outlined could form the agenda

**Remember that the detection of fraud often comes from piecing together information about small and seemingly insignificant matters**



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## Evaluating the effect of misstatements identified during the audit

- Before the auditor can form an audit opinion, there will need to be an evaluation of misstatements so that the auditor can consider the impact of misstatements on the audit and whether any additional procedures need to be performed
- **HKSA 450** *Evaluation of misstatements* identified during the audit, requires an auditor to evaluate:
  - ❖ the effect of **identified misstatements** on the audit;
  - ❖ the effect of **uncorrected misstatements**, if any, on the financial statements.

### **Point to note:**

**Remember that there will always be a risk of undetected misstatements in the financial statements. This is because of the inherent limitations of an audit**

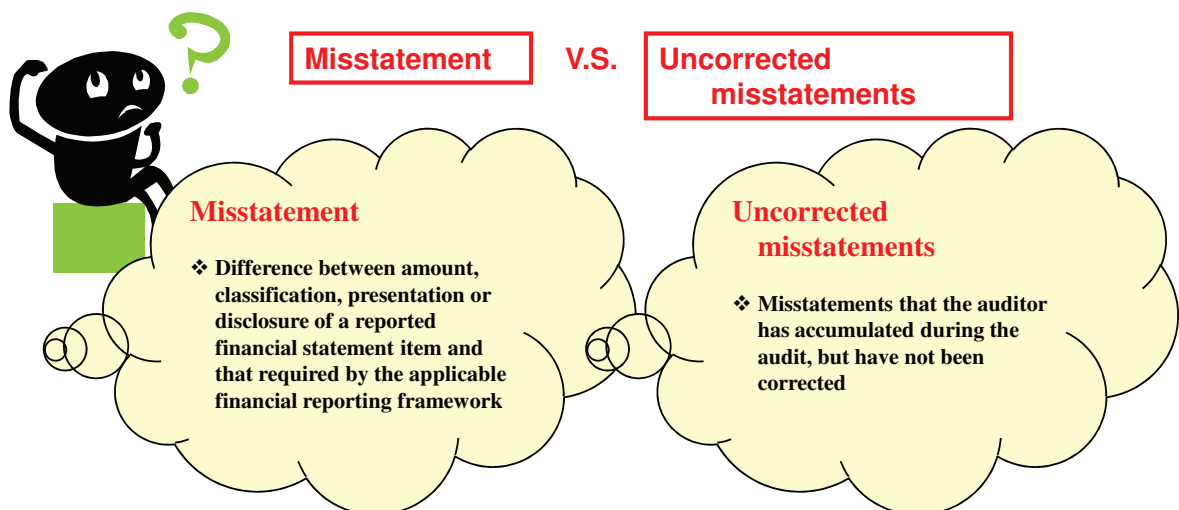


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## Evaluating the effect of misstatements identified during the audit (Cont'd)



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## Evaluating the effect of misstatements identified during the audit (Cont'd)



### How can misstatements arise?

They can arise from fraud or error as shown:

#### Inaccuracies

- ❖ Mistakes made by personnel in gathering or processing data used to prepare the financial statements

#### Omissions

- ❖ Some transactions may not be recorded either by mistake or deliberately



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## Evaluating the effect of misstatements identified during the audit (Cont'd)



### What are some typical examples?

- **Rationale for significant transaction**
- **Journal entries**
- **Estimation errors**
- **Errors in fair value**
- No business rationale for significant transactions that are outside the normal course of business, this could be a manipulation of the financial statements
- Inappropriate or unauthorised journal entries
- Management estimates may calculate incorrectly, overlook or misinterpret facts, use inappropriate assumptions or contain bias. There could be deliberate misstatement
- Disagreements with management's judgments with respect to the fair value of certain assets, liabilities, and components of equity



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## Evaluating the effect of misstatements identified during the audit (Cont'd)



### What are some typical examples (cont'd)?

- **Accounting policies**
  - The auditor may not agree with management as to the selection and use of certain accounting policies
- **Uncorrected misstatements in opening equity**
  - Uncorrected misstatements from prior periods would be reflected in opening equity. If not adjusted, they may also cause a misstatement in the current period financial statements
- **Estimation errors**
  - Management estimates may calculate incorrectly, overlook or misinterpret facts, use inappropriate assumptions or contain bias. There could be
- **Revenue recognition**
  - Overstatement or understatement of revenues (e.g., premature revenue recognition, recording fictitious revenues, or improperly shifting revenues to a later period)



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## Evaluating the effect of misstatements identified during the audit (Cont'd)



### What are some typical examples (cont'd)?

- **Disclosures**
  - Certain financial disclosures required by the accounting framework may be omitted, incomplete or inaccurate
- **Internal control weaknesses**
  - Misstatements could result from unexpected deficiencies in internal control



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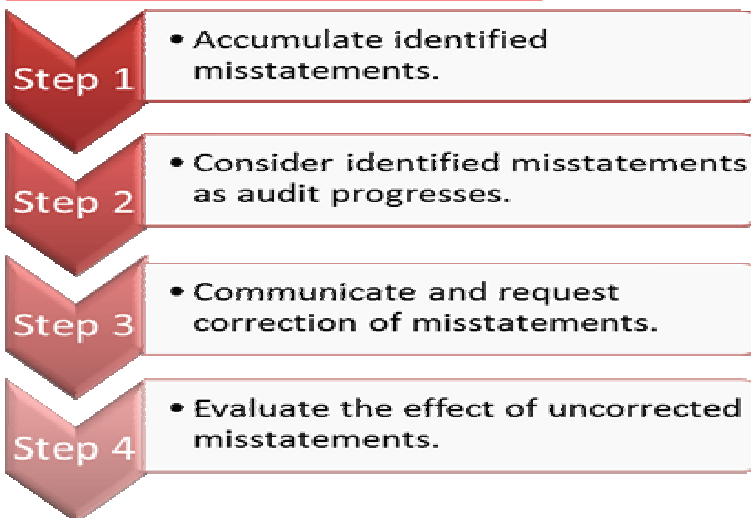
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# Evaluating the effect of misstatements identified during the audit (Cont'd)



## How to evaluate the effect of misstatements?

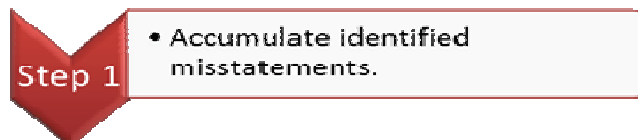


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## Step 1:



This will include aggregating:

- 1. factual misstatements**
- 2. judgemental misstatements** (differences in opinion between management and the auditor regarding judgemental areas)
- 3. projected misstatements** (the auditor's best estimate of what the total misstatement in a population will be by projecting the misstatement in a sample to the entire population from which the sample was drawn)

### Point to note:

- ❖ The auditor must aggregate all misstatement identified during the audit other than those which are 'clearly trivial'. This just means the auditor should not aggregate matters that are inconsequential whether taken individually or in aggregate. If the auditor is not sure whether a matter is trivial it is likely not to be 'clearly trivial'. 'Clearly trivial' is not another expression for 'not material' (Annex 1)
- ❖ Most quantitative misstatements can be aggregated so that the overall impact on the financial statements can be evaluated. However, some misstatements (such as incomplete or inaccurate financial statement disclosures) and qualitative findings (such as the possible existence of fraud) cannot be aggregated. These misstatements should be documented and evaluated on an individual basis

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## Step 2:

### Step 2

- Consider identified misstatements as audit progresses.

The auditor must **decide whether the audit plan needs to be revised** as the audit progresses if:

1. the auditor identifies misstatements which, because of their nature or circumstances, indicate that **other misstatements could also exist and if aggregated these could be material** eg, a misstatement that arose from a breakdown in internal control could indicate many other misstatements rather than an isolated occurrence
2. the aggregate of misstatements accumulated during the audit approaches determined materiality. **The risk of material misstatement rises as the aggregate of misstatements approaches the materiality threshold**
3. Sometimes the auditor may ask management to perform procedures to determine the actual misstatement and then to make adjustments to the financial statements, if the precise amount of misstatement in the population is not known. If this happens, the auditor will still need to do some additional procedures to determine if any misstatements remain



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## Step 3:

### Step 3

- Communicate and request correction of misstatements.

- The auditor must **communicate promptly** all misstatements accumulated during the audit **with the appropriate level of management** and request them to correct all misstatements other than those that are clearly trivial. The appropriate level of management will be the one that has the responsibility and authority to evaluate the misstatements and to take the necessary action
- If management **refuses to correct** some or all of the misstatements the auditor will **obtain an understanding of the rationale** for this and then use this when forming the opinion as to whether the financial statements as a whole are free from material misstatement

### Point to note:

- ❖ It is management's responsibility to adjust the financial statements to correct material misstatements (including inadequate disclosures) and to implement any other actions required



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## Step 4:

### Step 4

- Evaluate the effect of uncorrected misstatements.

- The auditor must **reassess materiality**, confirm whether it still is appropriate and then determine whether uncorrected misstatements are material individually or in aggregate (in relation to classes of transactions, account balances or disclosures and in relation to the financial statements as a whole)
- This involves consideration of:
  1. **the size and nature of misstatements**
  2. **the effect of uncorrected misstatements related to prior periods**



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## Step 4 (Cont'd)

- The auditor must **communicate uncorrected misstatements to TCWG** and the effect that they have on the audit opinion individually or in aggregate (as well as the effect of any prior period uncorrected misstatements)
- The auditor must request written representations from management and if appropriate TCWG, whether they believe the effects of uncorrected misstatements are immaterial individually and in aggregate to the financial statements as whole. **A summary of such items should be included in this representation**

### Point to note:

- ❖ **When the auditor communicates findings with those charged with governance, there is a requirement to identify material uncorrected misstatements individually**



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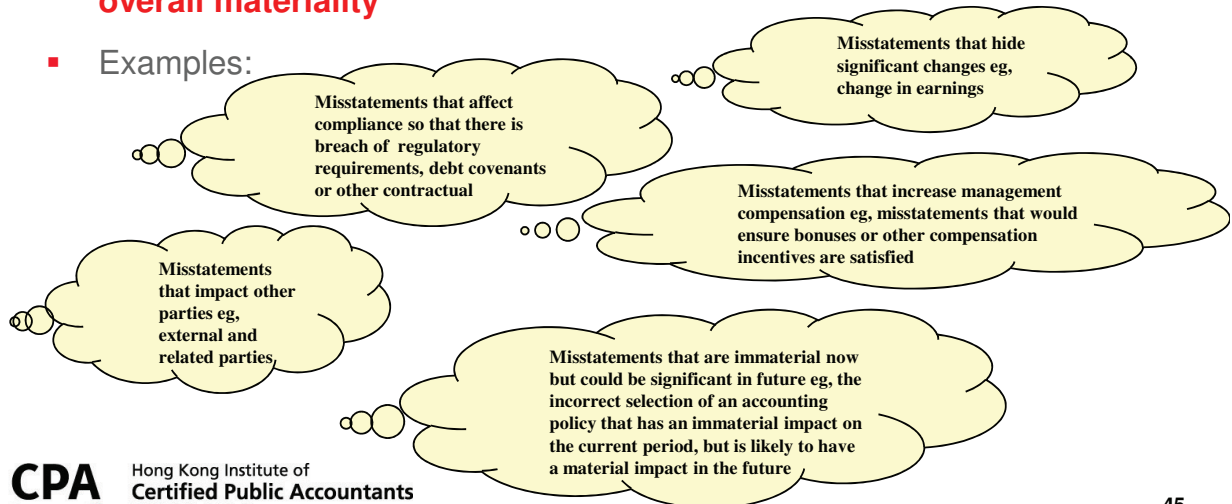
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## Other considerations when evaluating the effect of uncorrected misstatements

- Materiality depends on both the size and nature of matters. Hence an auditor may assess **some misstatements as material (individually or in aggregate) even if they are lower than overall materiality**

- Examples:



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## Evaluating the sufficiency and appropriateness of audit evidence

**HKSA 330** *The auditor's response to assessed risks* requires the auditor to:

- consider all relevant audit evidence** regardless of whether it appears to corroborate or contradict the assertions in the financial statements
- conclude whether sufficient appropriate audit evidence has been obtained**
- if the auditor has **not obtained** sufficient appropriate audit evidence as to a material financial statement assertion, the auditor **shall attempt to obtain further audit evidence**
- this is **not possible**, to **modify** the audit opinion

### Point to note:

- ❖ What constitutes sufficient appropriate audit evidence is ultimately a matter of professional judgement and will be influenced by factors



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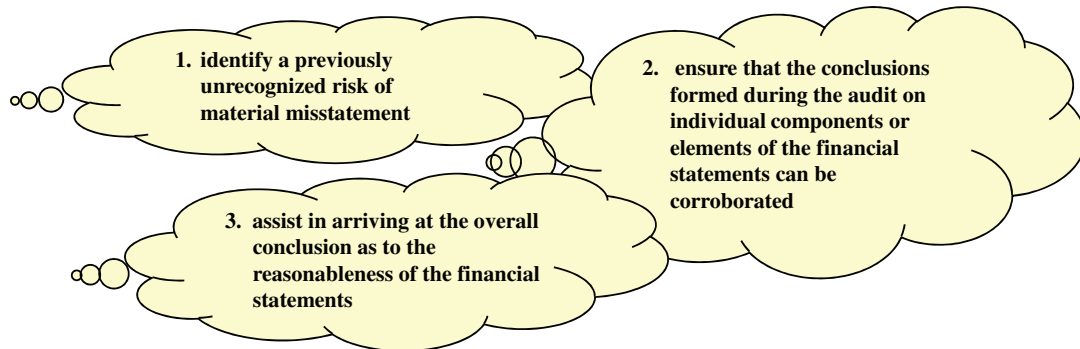
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## Final Analytical procedures

In addition to performing analytical procedures for the purposes of risk assessment and then later as substantive procedures, HKSA 520 Analytical procedures (AP) **requires** the auditor to **apply analytical procedures at, or near the end of the audit when forming an overall conclusion**

- The main purpose of undertaking AP at the end of the audit is to:



- The analytical procedures used at this stage may be similar to those that would be used as risk assessment procedures



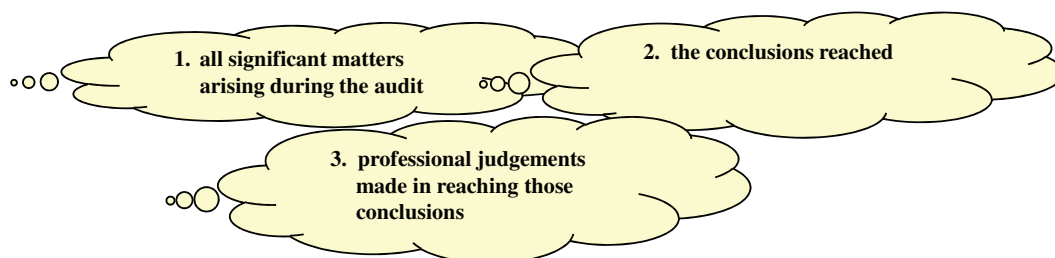
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## Documentation

Once the above evaluation has been completed, **HKSA 230 Audit documentation** requires that the auditor must **record**:



Practically many audit practitioners choose to record these items in a summary (sometimes called a '**completion memorandum**'). This document describes the items above and includes cross references to other relevant supporting documentation (Annex 2)

This summary helps **efficient reviews** and inspections particularly for large and complex audits. It also helps the auditor **consider** the **significant matters** and **assess** whether the auditor has **achieved their own objectives** as stipulated in the HKSAs



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# PART 3

## Management representation



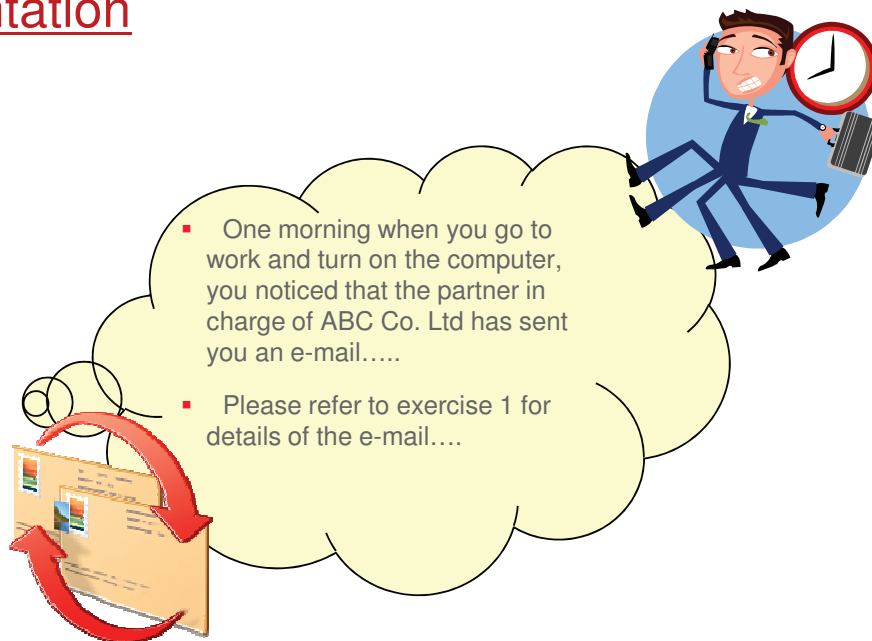
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### Scenario example: Management representation

Scenario



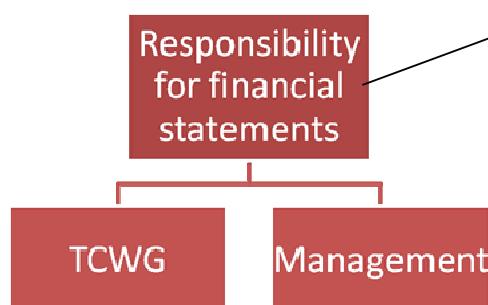
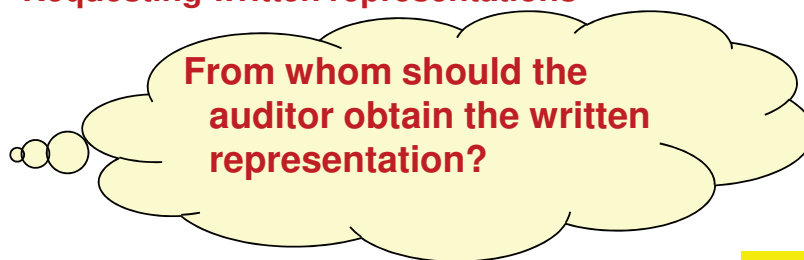
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# Management representations

## Requesting written representations



**Written representations are requested from those who are responsible for the preparation of the financial statements**



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# Management representations

## Written representations about management responsibilities

- Written representations from management are not enough without obtaining confirmation from management that it believes it has fulfilled its responsibilities



This is because it is very difficult for the auditor to be sure that the financial statements have been prepared and presented with full understanding of responsibilities by those who have prepared them eg, without asking for confirmation, how can an auditor be sure that management has provided the auditor with all relevant information agreed in the terms of the engagement letter?

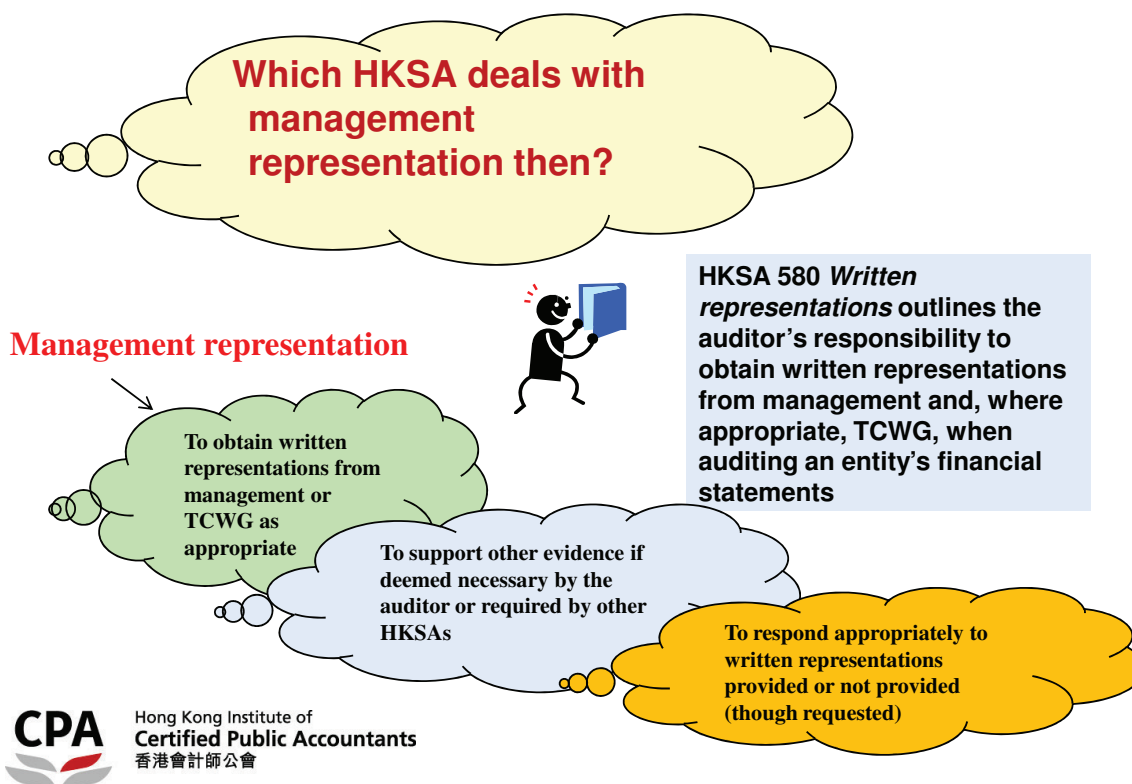


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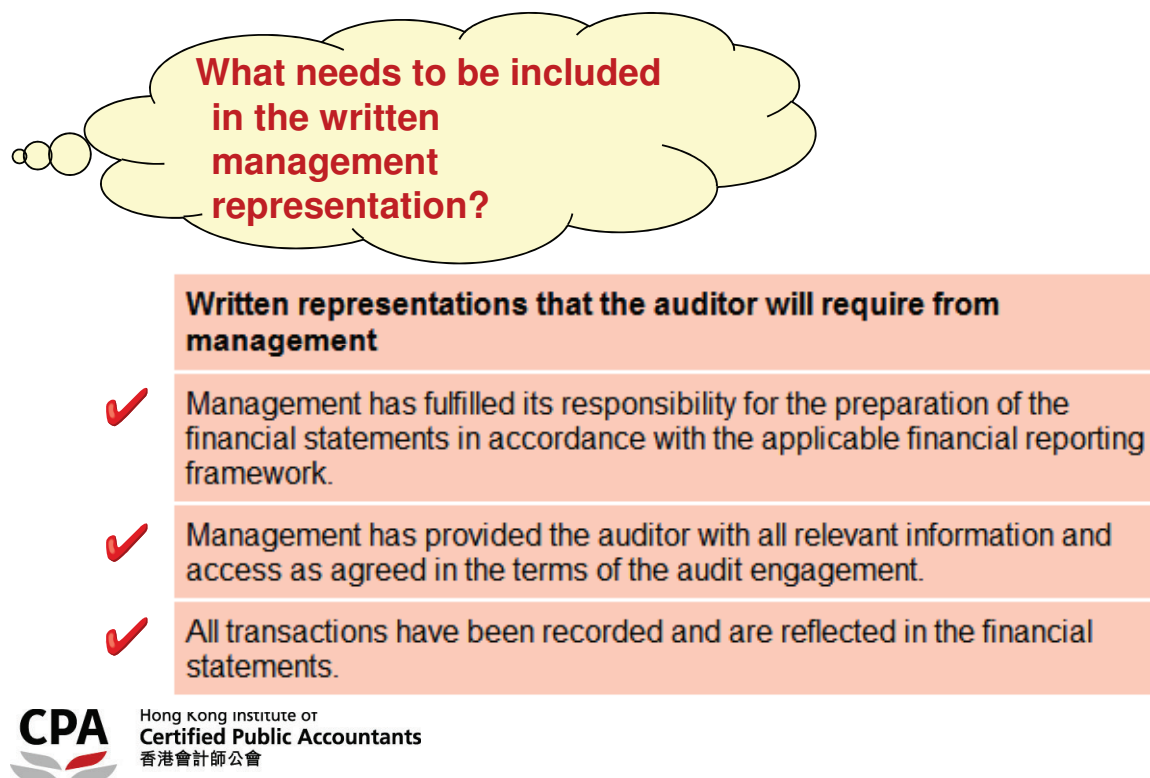
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## Management representations



## Management representations



# Management representations

## Other written representations

As well as representations about management responsibilities, specific HKSAs require the auditor to request written representations

Refer to Annex 6 & 7 for these specific HKSA

In addition the auditor may want to obtain more written representations to support other audit evidence. This may include written representations about:

- the financial statements (additional to specified requirements);
- information provided to the auditor (additional to specified requirements);
- specific assertions.



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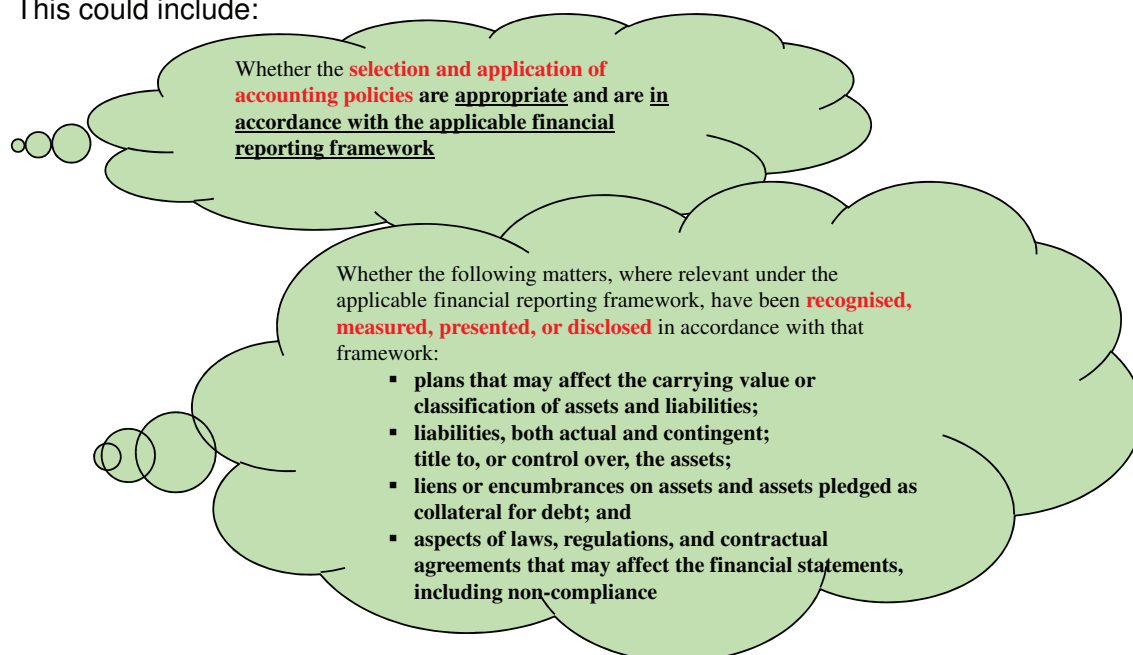
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# Management representations

## Additional representations about the financial statements

This could include:



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# Management representations

## Additional written representations about information provided to the auditor

This could include representations on whether management has communicated all known deficiencies in internal control that it is aware of



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# Management representations

## Written representations about specific assertions

When obtaining evidence about assertions which involve **judgements or intentions**, auditors will consider:

- Has the entity historically done what it has intended to?
- Can the entity actually take the course of action intended?
- Does other information contradict management's intention?



As well as this evidence, the auditor may request that management provide written representations to support this evidence e.g., if management play a significant role in determining the valuation basis of an entity's investments, **the auditor may need a written representation about their intentions over their investments** as the other evidence alone does not provide sufficient appropriate evidence



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# Management representations

## Other considerations:

	Comments
<b>Address letter to auditor</b>	The written representations would be included in a letter addressed to the auditor
<b>Date of letter</b>	The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements
<b>Period covered</b>	The written representations shall be for all financial statements and period(s) referred to in the auditor's report
<b>Signature</b>	Those responsible for the preparation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management is often the responsible party
<b>Unadjusted misstatements</b>	A list of uncorrected misstatements with individual amount exceed the clearly trivial is attached to the written representation letter



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# Management representations

## Other considerations (cont'd):

	Comments
<b>Qualifying language</b>	Management may include qualifying language to the effect that representations are made to the best of its knowledge and belief. Such wording can be accepted if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations
<b>Report to Those Charged With Governance</b>	HKSA 260 requires the auditor to communicate with those charged with governance the written representations which the auditor has requested, unless all of those charged with governance are involved in managing the entity
<b>Audit evidence</b>	Written management representations are <b>NOT</b> to be used as: <ul style="list-style-type: none"><li>• A substitute for performing other audit procedures; or</li><li>• As the sole source of evidence on significant audit matters</li></ul>



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# Management representations

## Reliability of representations

Doubts	Auditor's Required Response
Requested Representations Not Provided	<ul style="list-style-type: none"><li>• Discuss the matter with management;</li><li>• Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and</li><li>• Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.</li></ul>
Inconsistencies Identified	<ul style="list-style-type: none"><li>• Perform additional audit procedures to attempt to resolve the matter.</li><li>• If the matter remains unresolved, reconsider the assessment of the competence, integrity, ethical values, or diligence of management (see point below), or of its commitment to or enforcement of these, and determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general.</li></ul>



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# Management representations

## Reliability of representations

Doubts	Auditor's Required Response
Management Incompetence; Lack of Integrity or Ethical Values	<p>Determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.</p> <p>The auditor would disclaim an opinion on the financial statements where:</p> <ul style="list-style-type: none"><li>• The auditor concludes that there is sufficient doubt about the integrity of management such that the required written representations are not reliable; or</li><li>• Management does not provide the written representations required.</li></ul>



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## Link to a sample representation letter



[http://app1.hkicpa.org.hk/ebook/HKSA\\_Members\\_Handbook\\_Master/volumeIII/hksa580cfd.pdf](http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Master/volumeIII/hksa580cfd.pdf)



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## PART 4

### Communication with those charged with governance



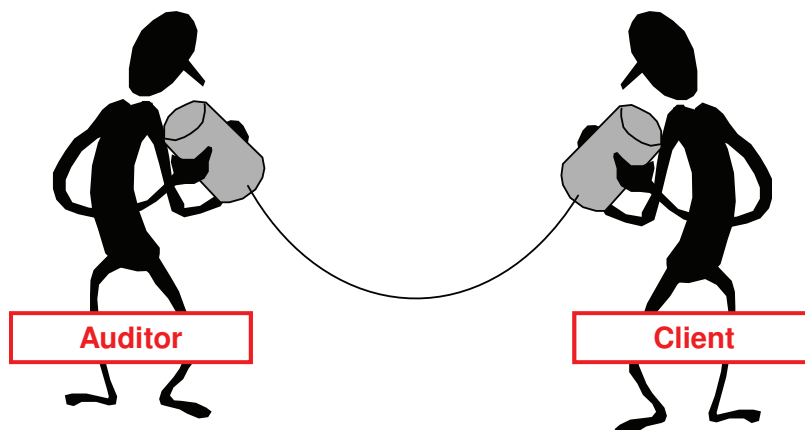
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## Communication with those charged with governance

- In order to effectively perform an audit engagement, it is essential that there is an open and transparent dialogue between the auditor and the entity being audited

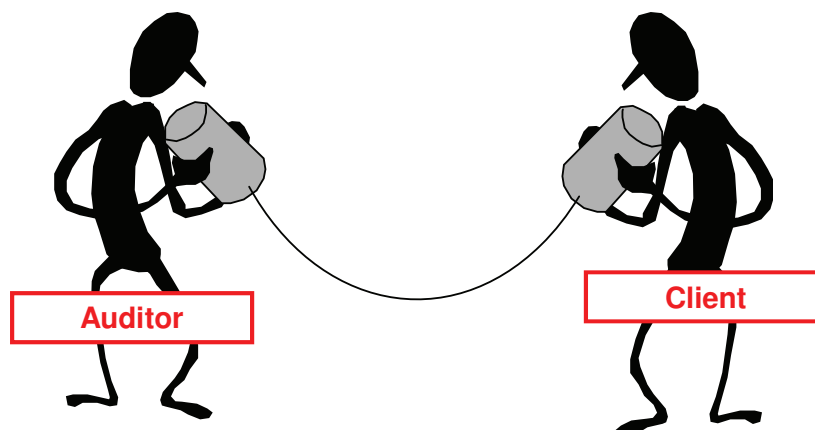


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## Communication with those charged with governance



- the auditor to communicate matters that are required by specific HKSAAs as well as other matters of interest

- those charged with governance at the entity to provide the auditor with information relevant to the audit e.g., information to help the auditor understand the entity better or locate particular sources of evidence



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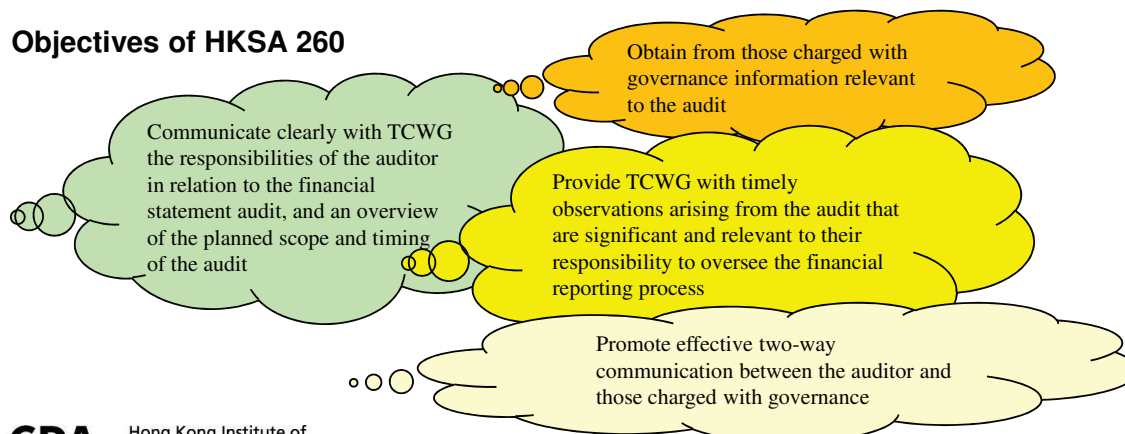
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# Communication with those charged with governance

**Two auditing standards** related to the requirements of communication with those charged with governance (TCWG)

- **HKSA 260** Communication with those charged with governance
- **HKSA 265** Communicating deficiencies in internal control to those charged with governance and management

## Objectives of HKSA 260



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# Those charge with governance (TCWG)



**What is the meaning of TCWG?**

<b>TCWG</b>	Person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the entity's accountability including overseeing the financial reporting process
<b>Management</b>	Persons with executive responsibility for the conduct of the entity's operations

**The auditor is required to determine the appropriate person(s) within the entity's governance structure with whom to communicate matters of governance interest i.e., TCWG**




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## Management vs those charged with governance



**What is the difference?**

- **Definition**
  - The definitions purposely do not specify who TCWG relates to in an entity

**Many entities vs smaller entities**

**Different jurisdiction may have different governance structures**

e.g. under a two-tier board structure, a supervisory board exist that is legally separate from an executive (management) board. In other jurisdictions, a single board has legal responsibility for supervisory and executive matters

e.g. Governance is often the collective responsibility of a governing body e.g. board of directors, supervisory board, partners, proprietors, committee of managers, council of governors, trustees etc

Whereas for smaller entity, one person may be charged with governance e.g. an owner-manager where there are no other owners or sole trustee

**Legal structure**

e.g. In some entities, TCWG hold positions that are an integral part of the legal structure e.g., company directors


In other entities e.g., government entities, a body that is not part of the entity is charged with governance

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## Management vs those charged with governance



**What does this mean practically for the auditor?**

- certain entities the auditor will be able to identify who TCWG are based on the legal framework, governance documentation (e.g., Constitution, Scheme of Delegation), and understanding of the governance structure and processes
- on occasion, the auditor may not be able to identify TCWG easily, perhaps where the governance structure is not formally defined, e.g. some not-for-profit organisations, government entities or family-owned entities etc
- the auditor will need to discuss with the person(s) who engaged the auditor to determine who fulfils the role of TCWG. It may be agreed that different matters should be reported to different parties depending on the subject matter



## Management vs those charged with governance



Scenario

In an entity where governance is the collective responsibility of a governing body, do auditor's communications be directed only to a sub group of TCWG, e.g. an audit committee?

**It depends!**

The auditor would need to determine whether communication was also required with the entire governing body based on:

- Subgroup and governing body responsibilities e.g. could the subgroup take action in relation to any matters communicated and provide further information and explanations?
- Nature of matters being communicated
- Legal or regulatory requirements



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## Communication with those charged with governance



**What are the matters to be communicated?**

HKSA 260 requires the following matters of governance interest to be communicated to TCWG:

- ✓ • auditor's responsibilities in relation to the financial statement audit
- ✓ • planned scope and timing of the audit
- ✓ • significant findings from the audit
- ✓ • auditor independence (for listed entities)



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## Matters to be communicated

### 1. Auditor's responsibilities

#### What should be communicated?

Confirmation that:

1. auditors are responsible for forming and expressing an opinion on financial statements (by performing the audit in accordance with HKSAAs);
2. auditors will communicate any significant matters arising from audit relevant to TCWG's role of overseeing financial statements;
3. an audit of the financial statements doesn't relieve management or TCWG of their responsibilities (to prepare the accounts and oversee them respectively)

#### How should these be communicated?

1. Usually an auditor will inform TCWG of their responsibilities by providing them with a copy of their engagement letter



**Auditors should make it clear that they are not responsible for identifying all matters connected with governance**

**Auditors should also state they must have regard to local laws and regulations and must comply with any local guidance e.g., by professional body, legal or regulatory requirements**



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## Matters to be communicated

### 2. Planned scope and timing of audit

#### What should be communicated?

An overview of the planned scope and timing of the audit to promote two way communication

1. To help TCWG better understand the impact of the audit, the issues of risk, the concept of materiality, and any areas where they want the auditor to focus or perform more work
2. To help the auditor better understand the entity and its environment

#### How should these be communicated?

1. Usually a mixture of the audit plan and discussions with TCWG

#### Examples of planning matters that can be communicated include:

- application of the concept of materiality in the audit;
- how significant risk of material misstatement will be addressed;
- the auditor's approach to internal controlUse of the work of internal audit
- The entity's objectives and strategies, and the related business risk
- Significant communications with regulators
- How TCWG oversees the effectiveness of internal control and the detection or possibility of fraud
- Action of TCWG in response to developments in accounting standards, corporate governance practices, exchange listing rules etc.



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## Matters to be communicated

### 3. Significant findings

#### What should be communicated?

- Significant qualitative aspects of entity's accounting practices, particularly in the accounts where the entity is allowed to make estimates and judgements when applying the financial reporting framework
- Significant difficulties encountered during the audit
- Significant matters discussed or corresponded and written representations that the auditor is requesting
- Other matters significant to the oversight of financial reporting process

1. Selection of or changes in accounting policy that could have material effect on financial statements
2. Judgements made in formulating sensitive financial statement disclosures e.g., related party disclosures

Refer to [Annex 5](#) for more examples.

1. Delays in receiving information from management
2. Inadequate time to complete the audit
3. Unavailability of expected information

1. Business conditions that could impact risk of material misstatement
2. Concerns about management's communication with other accountants on accounting or auditing matters
3. Significant disagreements with management

1. Significant audit adjustments
2. Uncorrected misstatements
3. Reasons for expected modifications to auditors report



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## Matters to be communicated

### 3. Significant findings

#### How should these be communicated?

- Normally in writing or if verbally, documented minutes of meeting to provide records of communication



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## Matters to be communicated

### 4. Auditors' independence

#### What should be communicated?

1. A statement that the engagement team and others in the firm as appropriate, the firm and, when applicable, network firms have complied with relevant ethical requirements regarding independence
2. Total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity
3. The related safeguards that have been applied to eliminate identified threats to independence to reduce them to an acceptable level

#### How should these be communicated?

- In writing



This applies to **listed entities**



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## Communication with those charged with governance

### Forms of communication

HKSA 260 explains that effective communication may involve structured presentations and written reports as well as less structured communications including discussions



#### Matters that should be communicated in writing:

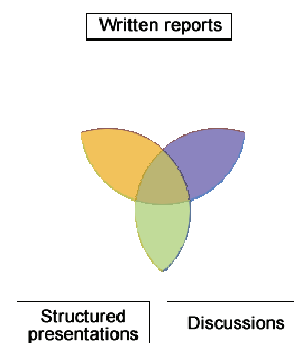
- Significant findings from the audit, if, oral communication would not be adequate
- Auditor's independence



**Where matters are orally communicated, the auditor should include a record of the discussion, e.g. copy of minutes, in the audit documentation and when and to whom the matter was communicated**



**All written communications should be retained**

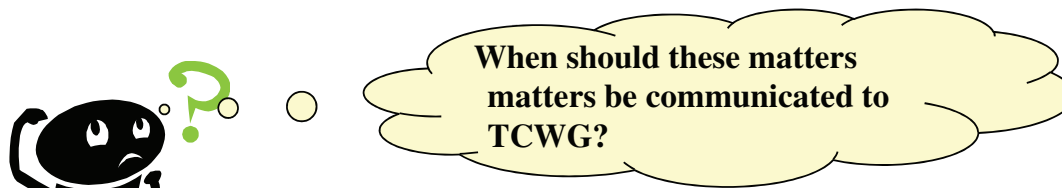


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## Timing of communications



▪ <b>Planning matters</b>	▪ Early in the engagement
▪ <b>Significant difficulty encountered</b>	▪ As soon as practicable
▪ <b>Independence issues</b>	▪ At a time when the auditor has to make a significant judgement on how to deal with a threat to independence e.g., when deciding whether to accept non-audit services from an entity for which it already does audit work
▪ <b>Findings from the audit</b>	▪ At the completion stage of the audit before the audit report is signed



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## Communication with those charged with governance

### Timing of communications

HKSA 260 requires that the auditor communicates with TCWG on a timely basis

This depends on the circumstances including the nature and significance of the matter and the action expected once reported to TCWG

Other relevant factors would include:

- size, structure and control environment of entity
- legal obligation to communicate matters
- expectations of TCWG
- timing that matter comes to attention of auditor



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# Communication with those charged with governance

## Auditors watch out



It is important to note that auditors have to be careful in relation to certain communications

### 1. Planned scope and timing

When communicating to TCWG about the planned scope and timing of the audit, the auditor mustn't give too much away so that it makes their work too predictable and therefore reduces the audit's effectiveness.



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# Communication with those charged with governance

## Auditors watch out (cont'd)

### 2. Communications with management

Also note that many matters may be discussed with management in the ordinary course of the audit including matters required to be communicated with TCWG. This is understandable given management's day to day responsibility for the entity's operations and for the preparation of the financial statements. It is quite acceptable for the auditor to discuss and clarify facts and issues with management first and to give them an opportunity to provide further information and explanations. This should only be avoided if the matter to report to TCWG relates to management's incompetence or lack of integrity



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# Communication with those charged with governance

## Auditors watch out (cont'd)

### 3. Communications with third parties

TCWG may wish to provide third parties e.g., bankers or regulatory authorities with copies of written communications from the auditor. It may be important in these cases that the third party be informed that the communication was not prepared with them in mind. The written communication to TCWG could state that:

- the communication has been prepared for the sole use of TCWG
- no responsibility is assumed to third parties
- there are restrictions on disclosure or distribution



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# Communication with those charged with governance

## Adequacy of communication

HKSA 260 also requires that the auditor should evaluate whether the two-way communication process has been adequate for the purposes of the audit. However the auditors do not have to actively design procedures to do the evaluation. The evaluation can be based on observations when performing other audit procedures.

If the auditor believes that two-way communication is inadequate then it may indicate an unsatisfactory control environment. This will then influence the auditor's assessment of the risk of material misstatement, which could impact the auditor's entire audit approach. Indeed if the situation can't be resolved it may require the auditor to take actions.



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# Communication with those charged with governance

## Adequacy of communication (cont'd)

### Potential auditor actions if two way communication inadequate

- Modify audit opinion on the basis of a scope limitation
- Obtain legal advice about consequences of different course of action.
- Communicate with third parties e.g., regulator or a higher authority in the governance structure outside the entity such as owners of the business.
- Withdraw from engagement if permitted under applicable law/regulation.



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# Communication with those charged with governance

## Supplementary matters

If the auditor becomes aware of **supplementary issues which do not necessarily relate to the financial reporting process**, but are likely to be **significant to the strategic responsibilities of TCWG**, the auditor must determine whether to communicate these matters to TCWG.

Examples of supplementary matters include significant issues regarding governance structures, or significant decisions or actions taken by management that lacked proper authorisation.



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# Communication with those charged with governance

## Supplementary matters (cont'd)

When determining whether to communicate these matters to TCWG, the auditor may discuss them with the appropriate level of management unless it is inappropriate to do so. If the auditor decides to communicate these matters to TCWG the auditor **may** wish to clarify the following with TCWG:

- that the identification and communication of these supplementary matters was incidental to the purpose of the audit;
- no procedures were undertaken by the auditor in respect to the supplementary matter, other than those that related to the opinion on the financial statements;
- no procedures were carried out to determine whether other such matters existed.

This is because these matters do not fall within the auditor's scope



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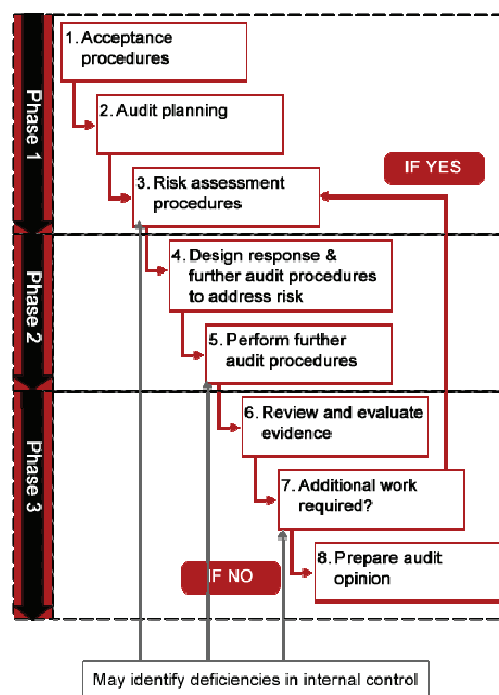
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# Communicating deficiencies in internal control

## Overview

During the course of the audit, the auditor may identify deficiencies in internal control. These could be identified at many stages of the audit but in particular, when undertaking risk assessment procedures and understanding and evaluating internal controls.

HKSA 265 *Communicating deficiencies in internal control* specifies which identified deficiencies the auditor is required to communicate to TCWG and management.



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# Communicating deficiencies in internal control

## Objectives

HKSA 265 states that the auditor's objective is to communicate appropriately to those charged with governance and management, deficiencies in internal control that:

- the auditor has **identified** during the audit; and
- in the auditor's professional judgement are of **sufficient importance** to merit their respective attentions.



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# Communicating deficiencies in internal control

## What is a deficiency in internal control?

A deficiency in internal control exists when:

- a control is designed, implemented or operated in such a way that it is unable to prevent, detect, and correct misstatements in the financial statements on a timely basis; or
- a control necessary to prevent, detect and correct misstatements in the financial statements on a timely basis is missing.



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# Communicating deficiencies in internal control

## What is a deficiency in internal control? (cont'd)

Have a look at some common control deficiencies:

### Entity level controls

1. Weak control environment (entity-level) controls such as ineffective oversight, poor attitude toward internal control, or instances of management override or fraud found.
2. Changes in personnel that have resulted in key positions being unfilled, or where current finance personnel are not competent to perform the required tasks.
3. Deficiencies identified in general IT controls
4. Inadequate controls implemented to address significant non-routine events such as the introduction of a new accounting system, the automation of a system such as sales, or the acquisition of a new business



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# Communicating deficiencies in internal control

## Entity level controls (Con't)

5. Inability by management to oversee the preparation of the financial statements. This could include the lack of:
  1. general monitoring controls (such oversight of financial accounting personnel);
  2. controls over the prevention and detection of fraud;
  3. controls over the selection and application of significant accounting policies;
  4. controls over significant transactions with related parties;
  5. controls over significant transactions outside the entity's normal course of business; and
  6. controls over the period-end financial reporting process (such as controls over non-recurring journal entries)



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# Communicating deficiencies in internal control

## Transaction level

1. An ineffective management response to identified significant risks (e.g., absence of controls over such a risk).
2. Misstatements were detected by the auditor when they should have been prevented or detected and corrected, by the entity's internal control.
3. The existing internal controls were not:
  1. sufficient to mitigate the risk (poor design); and/or
  2. operating as designed (poor implementation). This could result from poor training, lack of staff competence, or inadequate resources to perform the required tasks.



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# Communicating deficiencies in internal control

## Scenario example

A company is operating a payroll system. During the course of the audit, the auditor observes the following:

1. Warehouse employees are given individual security codes to punch into the main door key pad. This key pad also monitors the hours worked by the employees.
2. The payroll is prepared by a payroll clerk from hours worked information on a standard payroll IT package. The payroll is checked to individual records automatically by the system. The payroll is approved by the financial controller.
3. Wages are paid in cash and distributed weekly by the warehouse manager.

Which control(s) may be considered to have deficiency?



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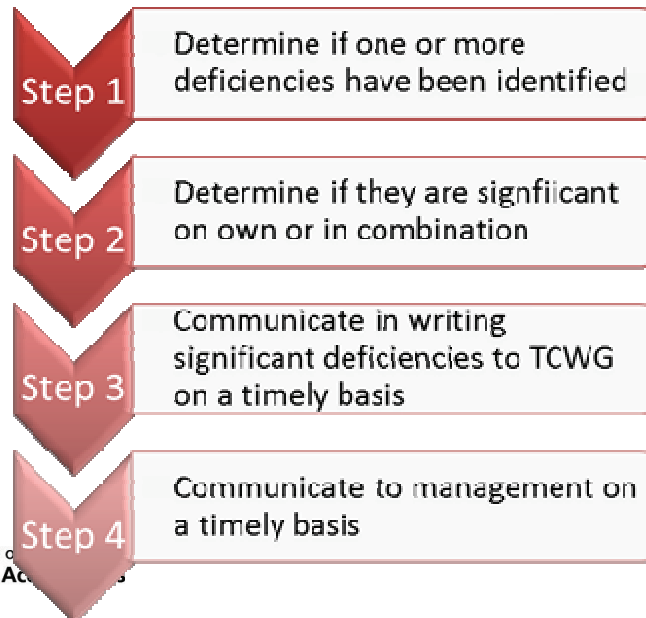
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# Communicating deficiencies in internal control

## Requirements

HKSA 265 requires the auditor to take four steps when dealing with deficiencies in internal controls



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# Communicating deficiencies in internal control

## Step 1 – how can the auditor determine if deficiencies in control have been identified?

The auditor may discuss the relevant facts and circumstances of the auditor's findings with the appropriate level of management. This discussion is a great opportunity to alert management to the existence of deficiencies which management may not have been aware of previously.

### What level of management?

The auditor will need to choose the appropriate level of management that is familiar with the internal control area concerned and has the authority to take remedial action on any identified deficiencies.



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# Communicating deficiencies in internal control

## Step 1 – how can the auditor determine if deficiencies in control have been identified?

During the discussion, the auditor may obtain other relevant information for further consideration, such as:

- Management's understanding of the actual or suspected causes of the deficiencies.
- Exceptions arising from the deficiencies that management may have noted, for example, misstatements that were not prevented by the relevant information technology (IT) controls.
- A preliminary indication from management of its response to the findings.



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# Communicating deficiencies in internal control

## Step 2 - How can the auditor assess the severity of the control deficiency?

A deficiency is significant if, in the auditor's professional judgement, it is of sufficient importance to merit the attention of TCWG.

The significance of deficiencies depends not only on whether a misstatement has actually occurred, but also on the **likelihood that a misstatement could** occur and the **potential magnitude of it**. This means that there may be a significant deficiency in a control even if the auditor has not identified any misstatements during the audit!



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## Communicating deficiencies in internal control

### Step 2 - How can the auditor assess the severity of the control deficiency? (cont'd)

#### Deficiency assessment criteria

Matters that could be considered when the auditor is assessing significance are below:

- Likelihood of deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility of an asset or liability to loss or fraud.
- The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.



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## Communicating deficiencies in internal control

### Step 2 - How can the auditor assess the severity of the control deficiency? (cont'd)

#### Deficiency assessment criteria (Con't)

- The importance of the controls to the financial reporting process.
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.



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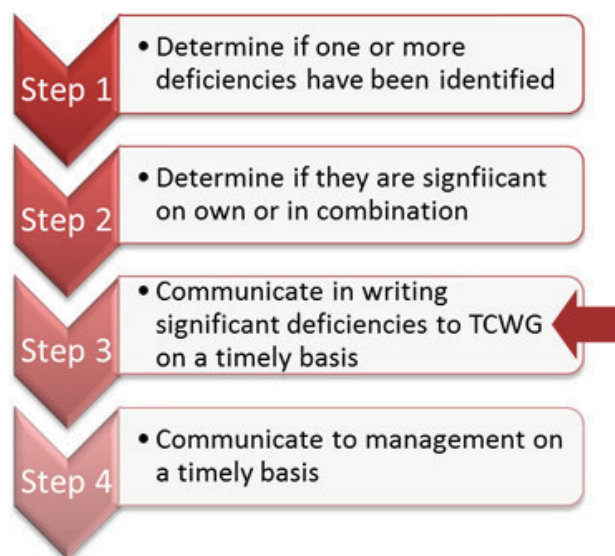
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## Communicating deficiencies in internal control

### Step 3 - Communicating significant deficiencies in internal control to TCWG

HKSA 265 requires this communication to be performed **in writing** due to the importance of the matters. This also means the auditors are in effect helping TCWG fulfill their oversight responsibilities.

The communication must be undertaken irrespective of the size of entity being audited. It is essentially a means of making sure that TCWG have been informed of problems.



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## Communicating deficiencies in internal control

### When should this happen?

As this written communication forms part of the auditor's documentation and audit file, auditors will need to ensure they comply with HKSA 230 *Audit documentation* which would ordinarily mean it should be issued not more than 60 days after the audit report.

Practically though auditors will consider whether it would be more helpful to TCWG to issue the communication much earlier.

The auditor may communicate these significant deficiencies orally in the first instance to management and then to TCWG to help them take remedial action to minimise the risks of material misstatement.

If the auditor does follow this approach, a written communication must still follow!



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# Communicating deficiencies in internal control

## How much detail should there be?

The written communication **must** include the following:

- a description of the deficiencies and an explanation of their potential effects
- sufficient information to enable TCWG and management to understand.
  1. Purpose of the audit was for the auditor to express an opinion on the financial statements
  2. The audit included consideration of internal control relevant to the preparation of the financial statements in order to design appropriate audit procedures, but not for the purpose of expressing an opinion on the effectiveness of internal control
  3. Matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to TCWG



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# Communicating deficiencies in internal control

## How much detail should there be? (cont'd)

The auditor may want to determine the level of detail depending on the:

- nature of the entity (is the entity of public interest?);
- size and complexity of the entity;
- nature of significant deficiencies identified; and
- what the governance composition is (i.e., the experience of TCWG);
- any legal or regulatory requirements (requiring specific formats).



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# Communicating deficiencies in internal control

## How much detail should there be? (cont'd)

The auditor **may** include the following:

- suggestions for remedial action on the deficiencies;
- management's actual or proposed responses;
- a statement as to whether or not the auditor has taken steps to verify whether management's responses have been implemented;
- an indication that if the auditor had performed more extensive procedures on internal control, more deficiencies may have been identified or some that were reported may not have been;
- an indication that the information is for TCWG only and not for other purposes.



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# Communicating deficiencies in internal control

**31 March 20X1**

**Audit Committee**

**ABC Corporation**

Dear Sirs,

**Re: Audit of 20X0 Financial Statements**

The objective of the audit was to obtain reasonable assurance that the financial statements were free of material misstatement. The audit was not designed for the purpose of identifying matters to communicate. Accordingly, the audit would not usually identify all such matters that may be of interest to you, and it is inappropriate to conclude that no such matters exist. During the course of our audit of ABC Corporation for the period ended December 31, 20X1, we identified the following deficiencies in internal control that, in our opinion, are significant. A significant deficiency or combination of deficiencies in internal control is one that, in our professional judgment, is of sufficient importance to merit the attention of those charged with governance.



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## Communicating deficiencies in internal control

### Unauthorized Journal Entries

#### **Deficiency**

There are currently no controls over manual journal entries made throughout the period. Without any segregation of duties and review controls over entries made, errors or misstatements can go undetected. Although our audit found no such material errors or misstatements, this current unrestricted and unmonitored access by all company personnel presents a risk to accuracy of the financial statements.

#### **Recommendations**

We recommend that proper segregation of duties be allocated based on roles and responsibilities. Further, a formalized review process should be established. All significant entries should be approved prior to entry, and a secondary review should be conducted by management on a monthly basis.



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## Communicating deficiencies in internal control

### Poor Inventory Controls

#### **Deficiency**

There are currently very limited controls over inventory. Without proper controls, inventory could be incomplete, improperly valued, or stolen.

#### **Recommendations**

We recommend ABC Corporation implement formalised controls over the tagging and periodic counting of inventory. Inventory records should be compared to actual products in the warehouse on a monthly basis. A visual inspection on a monthly basis of obsolete and damaged goods should also be performed to ensure that any inventory write-downs are recorded as required.

This communication is prepared solely for the information of management and is not intended for any other purpose. We accept no responsibility to a third party who uses this communication. Yours truly,

**XYZ Partners**



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## Communicating deficiencies in internal control

### What if it is very expensive for TCWG to rectify the deficiencies?

TCWG and management will have to assess the costs and benefits of implementing remedial actions when determining whether to remedy the deficiencies. The auditor however does not have to be concerned with this. The communication of significant deficiencies in internal control must be made by the auditor irrespective of this.



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## Communicating deficiencies in internal control

### What happens if a significant deficiency has been reported in a prior audit?

The auditor must still repeat the significant deficiencies if they remain. Of course practically the auditor could reference the previous communication rather than including the entire description of the significant deficiency again. The failure of TCWG or management to remedy a previously reported deficiency without a rational explanation could in itself be interpreted as being a significant deficiency!!



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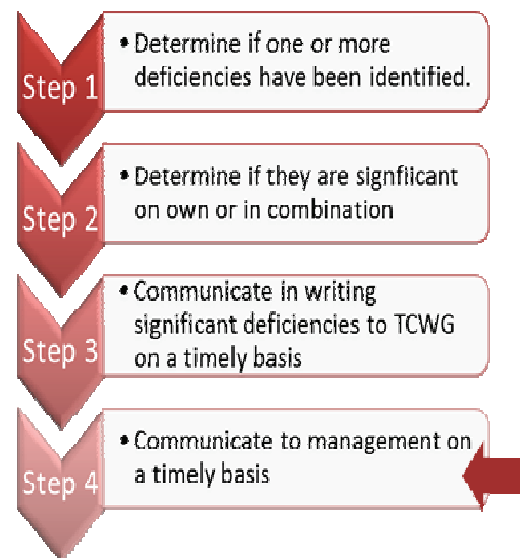
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# Communicating deficiencies in internal control

## Step 4 - Communicating deficiencies in internal control to management

HKSA 265 requires that the auditor should communicate to an appropriate level of management:

- in writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to TCWG unless it would be inappropriate to communicate to them directly;
- other deficiencies in internal control that have not been communicated to management by other parties and are of sufficient importance to merit management's attention.



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# Communicating deficiencies in internal control

## What happens if a deficiency other than a significant deficiency has been reported to management in a previous period?

If deficiencies other than significant ones have been previously reported to management and they have chosen not to remedy them due to cost or other reasons, the auditor **doesn't** need to repeat the communication. Though again it could be argued that if management don't bother to remedy other deficiencies that were previously communicated this may become a significant deficiency.

The only time it may be appropriate to re-communicate would be if:

- there has been a change in management;
- new information has come to light that alters the auditor's and management's prior understanding of the deficiencies.

This is different to communicating significant deficiencies with TCWG for which repeat communications are required if still outstanding.



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# PART 5

## Audit opinion and modification



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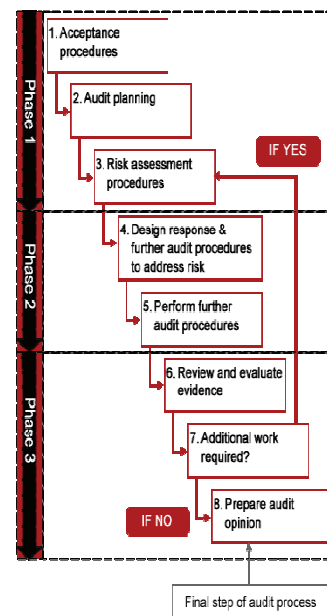
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## The final deliverables

**Auditor's report** - the end  
product of a financial  
statement audit



**Forming the audit opinion will be  
the final stage of the audit  
process**



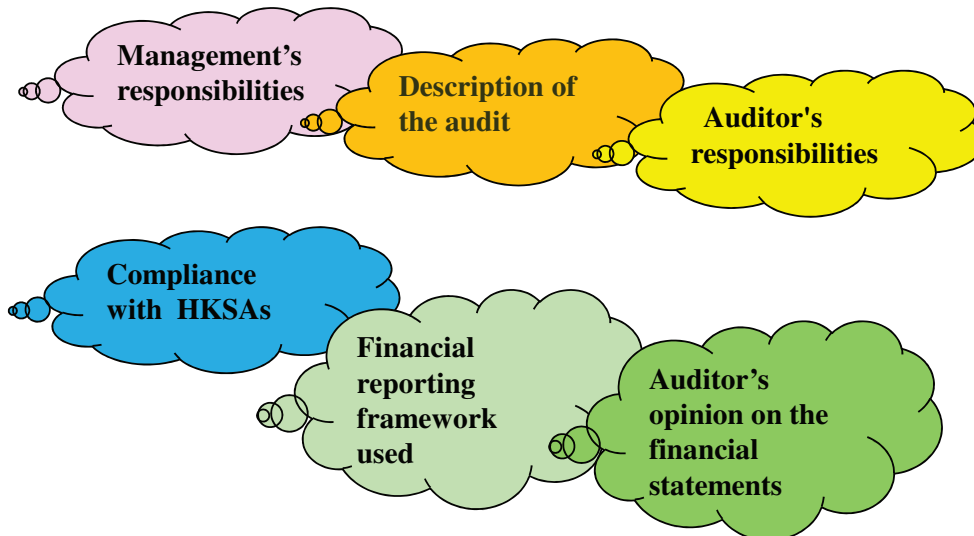
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## Auditor's report

- Auditor's report should communicate the following information to a reader:



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## Auditor's report

- **HKSA 700 requires the auditor's report to be issued in writing** (either in hard copy format or by electronic media) and to include certain headings and details. Details on each heading as follows:
  - Title
  - Addressee
  - Introductory paragraph
  - Management's responsibility for the financial statements
  - Auditor's responsibility
  - Auditor's opinion
  - Other reporting responsibilities
  - Signature of the auditor
  - Date of the auditor's report
  - Auditor's address



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## Auditor's report (cont'd)

### ▪ Title

- The title should indicate that it is the report of an **independent auditor** rather than a report issued by others

### ▪ Addressee

- The report should be **addressed to those for who the report is prepared**, typically the shareholders if the audit relates to a company. The addressee may depend on local regulations.



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## Auditor's report (cont'd)

### ▪ Introductory paragraph

This paragraph should:

1. identify the **entity** whose financial statements have been audited;
2. state that the financial statements have been **audited**;
3. identify the **title** of each of the **financial statements** that comprise the complete set of financial statements (**use page numbers to refer to them**); and
4. refer to the **summary of significant accounting policies** and other explanatory notes;
5. specify the **date and period covered** by the financial statements.



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## Auditor's report (cont'd)

### ■ Management's responsibility for the financial statements

This paragraph should explain that **management is responsible** for:

1. the **preparation** of the financial statements in accordance with the applicable financial reporting framework; and
2. such **internal control** as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

- If the financial statements are prepared in accordance with a fair presentation framework the explanation of management's responsibility should include reference to 'the **preparation and fair presentation of the financial statements** in accordance with the applicable financial reporting framework' or 'the **preparation of financial statements that give a true and fair view**'



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## Auditor's report (cont'd)

### ■ Auditor's responsibility

This paragraph should state that the **responsibility of the auditor is to express an opinion on the financial statements based on the audit**. This includes:

1. stating that the audit was conducted in accordance with the Hong Kong Standards on Auditing (that requires compliance with ethical requirements and that the auditor plans and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement);
2. describing an audit; and
3. stating that the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion

- Where financial statements are prepared in accordance with a fair presentation framework the description of the audit shall refer to 'the entity's preparation and fair presentation of the financial statements' or 'the entity's preparation of financial statements that give a true and fair view,' as appropriate in the circumstances



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## Auditor's report (cont'd)

### ▪ Auditor's opinion

This paragraph should be headed “**Opinion**”

For an unmodified opinion, the phrases used would include:

#### ▪ **Fair Presentation Framework**

A statement whether the financial statements present fairly, in all material respects, (or give a true and fair view of) in accordance with the applicable financial reporting framework, or such similar wording as required by law or regulation

#### ▪ **Compliance Framework**

A statement whether the financial statements are prepared in all material respects in accordance with the applicable financial reporting framework



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## Auditor's report (cont'd)

### ▪ Other reporting Responsibilities

Certain local standards, laws, or generally accepted practice may require or permit the auditor to report on other responsibilities. Such matters would be addressed in this paragraph following the auditor's opinion. This may include commenting on matters such as:

1. the adequacy of the entity's accounting records;
2. specific matters if they come to the auditors attention during the course of the audit;
3. results of performing additional specified procedures

### ▪ Signature of the auditor

The signature will **either be in the name of the audit firm or the personal name of the auditor or both**. It will depend on the local requirements. In certain jurisdictions the auditor may need to demonstrate that the auditor/firm has been approved by the local licensing authority in that jurisdiction



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## Auditor's report (cont'd)

### ▪ Date of the auditor's report

The auditor's report will be **dated no earlier than the date** on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements. This evidence will include:

1. consideration of the effect of events and transactions of which the auditor became aware up to the date of the auditor's report
2. the preparation of a complete set of financial statements
3. those with the recognised authority asserting responsibility for the financial statements

### ▪ Auditor's address

This will indicate the **location in the jurisdiction where the auditor practices**



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## Supplementary information

- If **supplementary information**, that is not required by the applicable financial reporting framework, is **presented** with the audited financial statements then it should be **clearly differentiated from the audited financial statements**. The exception to this rule is if it is an integral part of the audited financial statements.
- If it is **not clearly differentiated**, the auditor has to **ask management to change how it is presented**
- If management will **not change** the presentation the auditor must **explain** in the auditor's report that this **supplementary information has not been audited**



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## What does the auditor's report look like?

- HKSA 700 includes proformas to enable auditors to produce consistent reports. Take a look at these for the two alternative frameworks
  - **Fair presentation framework (Annex 3)**
  - **Compliance framework (Annex 4)**



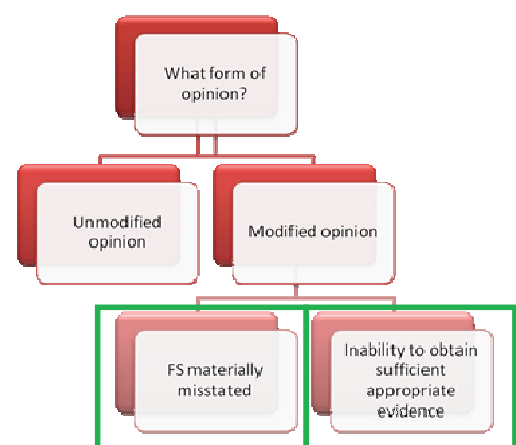
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## Modifications to the Auditor's Report

- There are two circumstances in which the auditor will need to modify the auditor's report (detailed in **HKSA 705 Modifications to the opinion in the independent auditor's report**):
  - if the auditor concludes that based on the audit evidence obtained the **financial statements ('FS') as a whole are not free from material misstatement**
  - If the auditor is **unable to obtain sufficient appropriate evidence** to conclude that the financial statements are free as a whole from material misstatement



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# Modifications to the Auditor's Report (Con't)

Financial Statements are materially misstated due to:	Inability to obtain sufficient appropriate audit evidence due to:
<ul style="list-style-type: none"> <li>• uncorrected misstatements that are material</li> <li>• accounting policies selected that are not appropriate</li> <li>• selected accounting policies that have not been properly applied</li> <li>• disclosures in financial statements that are not appropriate or adequate</li> </ul>	<ul style="list-style-type: none"> <li>• circumstances beyond the control of the entity eg, when accounting records have been destroyed due to fire, flood or theft</li> <li>• circumstances relating to the auditor's nature or timing of work eg, if the auditor cannot observe the counting of the physical inventories</li> <li>• limitations imposed by management eg, restricting access to key personnel or records</li> </ul>



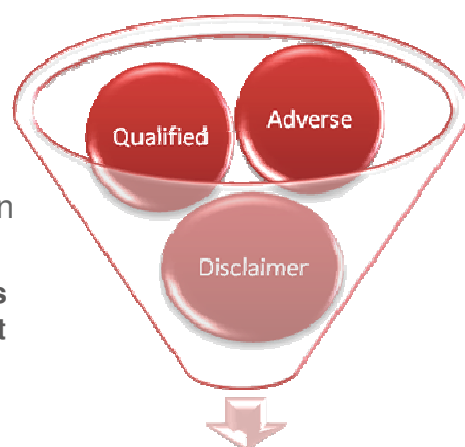
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## How is the opinion modified?

- There are **three types of modification**:
  - **qualified**
  - **adverse**
  - **disclaimer**
- In order to determine which type of modification is relevant the auditor has to decide:
  - What is the **reason for the modification** ie, is there a material misstatement or insufficient inappropriate evidence?
  - What is the **effect of the misstatement(s)**? - material but not pervasive; or material and pervasive



**Types of modified opinion**



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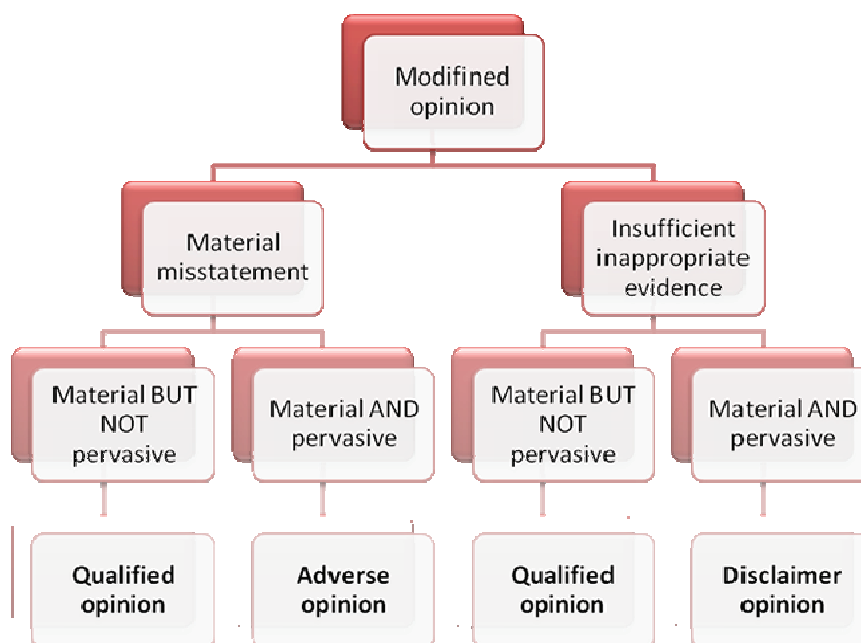
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## How is the opinion modified (cont'd)?

- To be **pervasive** in the auditor's judgement the effect of the misstatement must:
  - not be confined to specific elements, accounts or items** of the financial statements (eg, just one balance);
  - if so confined, represent or could **represent a substantial proportion** of the financial statements;
  - be in relation to **disclosures that are fundamental** to a user's understanding.
- Once this judgment has been made the type of opinion will be assigned as shown in the diagram in the next slide. **'Qualified opinions'** are assigned for either circumstance of modification as long as the **misstatement is material but not pervasive**. If the **misstatement is material and pervasive** then, dependent on the circumstances of modification, the opinion will **either be 'adverse' or 'disclaimer'**

## How is the opinion modified (cont'd)?



## Changes required to the audit report when modifying the opinion

- When a modification is required, the details of the modification need to be provided in a '**basis for modification**' paragraph shown **before the opinion paragraph** and depending on the type of modification would be headed:
  - **Basis for Qualified opinion**
  - **Basis for Adverse opinion**
  - **Basis for Disclaimer of opinion**



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## Changes required to the audit report when modifying the opinion

- The auditor would include in this paragraph:
  - the **main reasons** for qualification
  - if possible, **quantification of the possible effect** on the financial statements or a statement to say that this is not possible
  - if the material misstatement relates to disclosures, an **explanation** of the disclosures that are misstated
- The opinion paragraph will also be headed dependent on the type of opinion:
  - **Qualified opinion**
  - **Adverse opinion**
  - **Disclaimer of opinion**
- It will have changes made to reflect the modification (as shown in later slides)
- Note that when the auditor expects to modify the audit opinion in the auditor's report **the auditor should communicate with TCWG the circumstances that led to the expected modification and the proposed wording**



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## Changes required to the audit report when modifying the opinion (Con't)

- **Qualified opinion**

Except for the effects of the matter described in the Basis for Qualified Opinion paragraph...

- **Adverse opinion**

In our opinion because of the significance of the matters discussed in the Basis for Adverse Opinion paragraph.....the financial statements do not present fairly...

- **Disclaimer of opinion**

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence on which to provide a basis for an audit opinion. Accordingly we do not express an opinion on the financial statements.



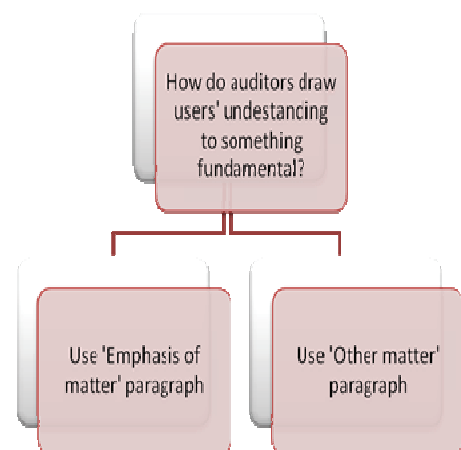
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## Emphasis of matter and other matter paragraphs

- Sometimes having formed the opinion, the auditor must draw users' attention to matters that although appropriately disclosed in the financial statements, are of such importance that it is 'fundamental to users' understanding of the financial statements' (requirement of **HKSA 706** *Emphasis of matter paragraphs*).
- The auditors achieve this additional communication by adding an extra paragraph to the auditor's report **after** the audit opinion (but before the heading titled 'Report on Other Legal and Regulatory Requirements').
- **Emphasis of matter and Other matter paragraphs are not modifications to the audit opinion**



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## Emphasis of matter paragraphs (cont'd)

- This paragraph is used to highlight important matters already disclosed in the financial statements that will enhance the users understanding of the financial statements. The paragraph would not include more detail than is already presented in the financial statements and the auditor would have to obtain sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements
- The auditor would include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the notes to the accounts. **The auditor would also need to make it clear that the auditor's opinion is not modified in respect of the matter emphasised**



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## Emphasis of matter paragraphs (Con't)

- Auditors must use emphasis of matter paragraphs when the **going concern assumption has been used appropriately but there is material uncertainty over the ability of an entity to continue as going concern** (which has been disclosed by the entity properly in a note). In this case, a modification will not be required as the entity has presented and disclosed information appropriately, however due to the significance of this material uncertainty the auditors must alert users to this issue and will therefore refer to it in the auditor's report.



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# Emphasis of matter paragraphs (Con't)

## Extract from Auditor's report

### Emphasis of matter

We draw attention to Note X in the financial statements which describes the material uncertainty related to negotiations to secure replacement finance for a credit facility which is due to expire on 24 July 20X1. The material uncertainty casts significant doubt on the group and parent company's ability to continue as a going concern.

Our opinion is not qualified in respect of this matter.



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# Emphasis of matter paragraphs (Con't)

## Scenario example

- ABC Enterprises has been taken to court by an IT supplier over a breach of licence conditions. ABC Enterprises has lodged a counter claim against the supplier and preliminary hearings are in the process of being heard. The figures in the case are considered to be significant. The solicitors have advised that the outcome cannot be predicted and no provision has been made in the financial statements as a result although a contingent liability has been disclosed in the notes in accordance with the applicable financial reporting framework.
- **Auditor response**  
The auditor agrees with the treatment in the financial statements therefore will issue an unqualified opinion, but must include an emphasis of matter paragraph cross-referenced to the note in the financial statements due to the significant uncertainty.



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## Emphasis of matter paragraphs (Con't)

### Extract from the Independent Auditor's Report

#### Opinion

In our opinion, the financial statements present fairly, in all material respects the financial position of ABC Enterprises as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended, in accordance with Hong Kong Financial Reporting Standards.

#### Emphasis of Matter

We draw attention to Note 5 to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the company by ZBX Co. Our opinion is not qualified in this matter.



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## Other matter paragraphs

- An 'other matter' paragraph may be used to **highlight matters that are not already disclosed** in the financial statements that would be relevant to the users' understanding of the audit, the auditor's responsibilities and/or the auditor's report eg,
  - to explain why an auditor is unable to resign from an audit eg, if there was insufficient or inappropriate evidence which had a material and pervasive impact because management would not provide information but it was not practicable for the auditors to withdraw from the audit;
  - to elaborate on auditor's responsibilities as required by local laws or regulations;
  - to draw attention to the fact that the auditor's report is intended solely for the intended users and should not be distributed to other parties; and
  - to draw users' attention to a second set of financial statements and auditor's report prepared in relation to the same entity where an entity has prepared two sets of financial statements under different frameworks and the auditor has been engaged to report on both.



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## Other matter paragraphs (Con't)

- The information presented must not contradict the opinion or items disclosed in the financial statements. The wording should also reflect that the matter does not need to be presented and disclosed in the financial statements
- When an 'other matter' paragraph is included to draw users' attention to a matter relevant to their understanding of the audit of the financial statements, the paragraph is included immediately after the Opinion paragraph
- In other circumstances it may be included within the 'Report on Other Legal and Regulatory requirements' section of the auditor's report or as a separate paragraph following this section



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## Other matter paragraphs (Con't)

- **Extract from Auditor's report from an 'other matter' report**
- **Other matter**
  - We draw attention to the Director's Report, which states that Entity X is "one of the largest retailers in the world". We believe this to be a material misstatement of fact. Our audit opinion is not qualified in this matter as this information is not required to be disclosed or presented in the financial statements...



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# Thank you for your attention

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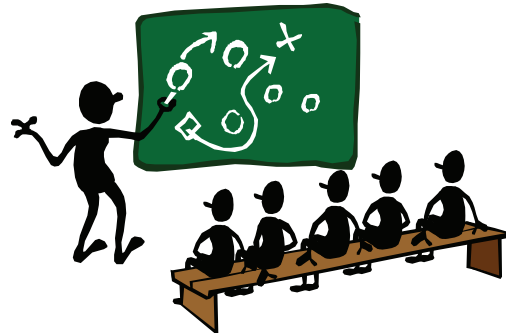
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Presented by : Winnie Chan, Associate Director, Technical Learning and Support, HKICPA  
Eky Liu, Manager, Technical Learning and Support, HKICPA  
Venue: The Hong Kong Institute of Certified Public Accountants

# ***A Refresher Course on Current Auditing Standards 2013 (Day 4)***



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## PART 6

### Quality control in general



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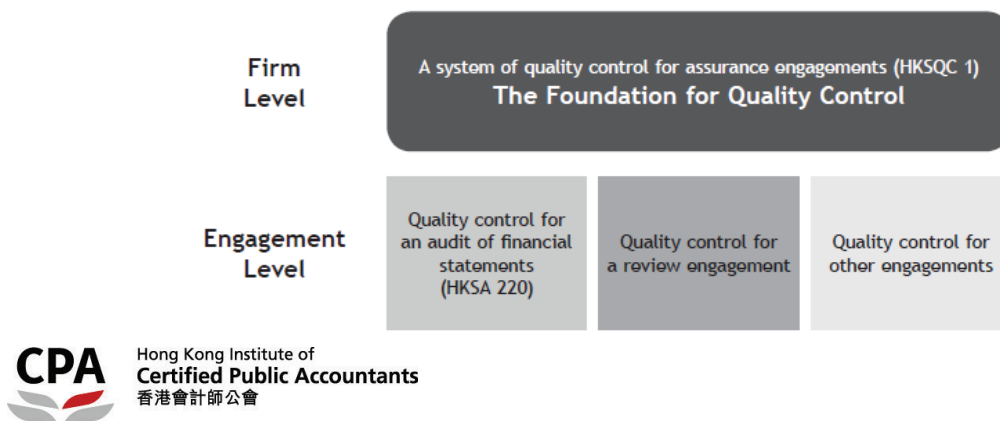
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# Quality Control

## Overview

### Which standards talk about the quality control aspects of engagement?

- HKSA 200 Quality control for an audit of financial statements
- HKSQC 1 Quality control for firm that performs audits and reviews of financial statements, and other assurance and related services engagements



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# Quality Control

## What are the benefits of a quality control system?

### • Quality control procedures ensure that:

- ❖ Standards of all work completed is high and consistent
- ❖ Quality of work can be measured against a standard and monitored
- ❖ Individuals know what to do, receive on-going support and find out whether their work is completed to the required standards

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# Quality Control

What are the elements of a quality control system?

- There are six key elements of a quality control system. Find out more about these for both firms and audits.....



1. Leadership

2. Relevant ethical requirements



3. Acceptance and continuance



4. Human resources

5. Engagement performances

6. Monitoring



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## 1. Leadership requirements

FIRM	AUDIT
<ol style="list-style-type: none"> <li>1. Establish policies and procedures to promote internal quality culture</li> <li>2. Firm's partners should assume responsibility for quality control</li> </ol>	<ol style="list-style-type: none"> <li>1. Engagement partner (EP) should take responsibility for quality on each audit that the partner is assigned to</li> <li>2. The EP is the partner who is responsible for the audit and for the audit report issued on behalf of the firm</li> </ol>

Tone at the Top



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# Leadership Responsibility Pyramid



## Hints:

At regularly scheduled staff meetings, it is suggested that you remind all partners and staff to adhere to the quality control policies and procedures of the firm and to utilize the tools available to assist engagement teams with the requirements. Invite comments and suggestions for improvement and allow time for questions. These gatherings could also be used as a vehicle to communicate the recognition and rewards available to partners and staff who demonstrate a commitment to the firm's quality control system.



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## 2. Relevant ethical requirements

FIRM	AUDIT
<ol style="list-style-type: none"> <li>1. Establish policies and procedures to ensure that firm and staff comply with ethical requirements</li> <li>2. Establish policies and procedures to ensure firm and staff maintain independence requirements where required so that the firm can assess and evaluate threats to independence</li> <li>3. These policies and procedures will include requirements for: <ul style="list-style-type: none"> <li>• EP to inform firm about client engagements for <u>firm-wide review of independence threats</u>;</li> <li>• <u>prompt notification by staff of threats to independence or breaches</u></li> </ul> </li> </ol>	




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## 2. Relevant ethical requirements (cont'd)

FIRM	AUDIT
<p>4. At least <b>annually</b>, the firm should obtain <u>written communications of compliance</u> with its policies from all staff required to be independent</p> <p>5. Establish policies and procedures setting out criteria for determining safeguards <u>to reduce familiarity threat to acceptable level when using the same senior personnel for a long time</u></p> <p>6. Audits of public interest entities require <u>key audit partner rotation</u> after a specified period</p> 	<p>1. Engagement partner (EP) should stay alert during the audit for evidence of breaches of ethical requirements by engagement team members and take action if required</p> <p>2. EP should form a conclusion on compliance with independence by identifying and evaluating circumstances/relationships that create threats and taking appropriate action to eliminate threats or reduce them to an acceptable level</p> <p>3. If necessary, the EP should report to the firm any matters that cannot be resolved and may have to consider withdrawal from the engagement</p>

## 3. Acceptance and continuance

FIRM	AUDIT
<p>1. Establish policies and procedures for acceptance and continuance of client relationship so that the firm will only undertake or continue relationships where the firm:</p> <ul style="list-style-type: none"> <li>• is competent to perform the engagement and has resources</li> <li>• can comply with ethical requirements</li> <li>• has considered the clients integrity and do not have information that would lead to conclude that the client lacks integrity</li> </ul>	<p>1. Engagement partner (EP) should satisfy themselves that appropriate procedures regarding the acceptance and continuance of client relationship and audit engagements have been followed</p> <p>2. If the EP becomes aware of something that would have caused the audit engagement to be declined, they should communicate it to the firm promptly</p>

## 4. Human resources requirements

FIRM	AUDIT
<ol style="list-style-type: none"> <li>1. Establish policies and procedures to ensure that the firm has sufficient staff with the <u>competence, capabilities and commitment to ethical principles</u> necessary to perform engagements in accordance with professional standards and applicable legal and regulatory requirements and issue appropriate reports</li> <li>2. Establish policies on all aspects of employing professional staff including <u>recruitment, performance evaluation, career development, promotion, compensation</u> etc.</li> <li>3. Assign responsibilities to each engagement team members, including engagement partner</li> </ol>	<ol style="list-style-type: none"> <li>1. Engagement partner should satisfy themselves that the engagement team collectively have the appropriate competence and capabilities to <ul style="list-style-type: none"> <li>• perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements</li> <li>• enable the issue of an appropriate audit report</li> </ul> </li> </ol>

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## 5. Engagement performance

FIRM	AUDIT
<ol style="list-style-type: none"> <li>1. Establish policies and procedures to ensure that <ul style="list-style-type: none"> <li>• engagements are performed in accordance with professional standards and applicable legal and regulatory requirements</li> <li>• appropriate reports are issued</li> </ul> </li> <li>2. Such policies and procedures should include <ul style="list-style-type: none"> <li>• matters to promote <u>consistency in the quality</u> of engagement performance</li> <li>• <u>supervision</u> responsibilities</li> <li>• <u>review</u> responsibilities</li> </ul> </li> </ol>	

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## 5. Engagement performance (cont'd)

FIRM	AUDIT
<ol style="list-style-type: none"> <li>Review responsibilities should be based on the work of less experienced team members being reviewed by more experienced team members</li> <li>Establish policies and procedures in relation to <u>consultation, engagement quality control reviews and engagement documentation</u></li> </ol>	<ol style="list-style-type: none"> <li>Engagement partner (EP) should take responsibility for the direction, supervision and performance of the audit to ensure <ul style="list-style-type: none"> <li>The audit engagement is performed in accordance with professional standards and applicable legal and regulatory requirements</li> <li>The audit report is appropriate in the circumstances</li> </ul> </li> <li>Engagement partner should take responsibility for reviews being performed in accordance with the firms review policies and procedures</li> <li>On or before the date of the auditor's report, the EP should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached through: <ul style="list-style-type: none"> <li>a review of the audit documentation</li> <li>discussion with the engagement team</li> </ul> </li> </ol>



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## 6. Monitoring

FIRM	AUDIT
<ol style="list-style-type: none"> <li>Establish policies and procedures to ensure that the system of quality control is relevant, adequate and operating effectively <u>through on-going evaluation or periodic review of selected engagement files</u></li> <li><u>Evaluate the effect of deficiencies</u> noted when monitored and determine whether they are systematic, repetitive and require prompt corrective action</li> <li>Communicate to relevant engagement partners and other staff any deficiencies noted and <u>recommendations for remedial action</u></li> </ol>	



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## 6. Monitoring (cont'd)

FIRM	AUDIT
4. Establish procedures to address cases where monitoring reveals that reports issued were inappropriate or procedures were omitted	1. Engagement partner should consider the results of the firms monitoring process and whether deficiencies noted may affect the audit engagement



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## Documentation

- ❖ HKSQC1 (and HKSA 220) requires policies and procedures to ensure:
  - a) Prompt assembly of files after reports are finalised
  - b) Safe custody, integrity, confidentiality, accessibility and retrievability of documentation
  - c) Retention of engagement documentation for a period sufficient to meet the firm's needs and legal requirements
- ❖ Firms should establish policies requiring documentation to provide evidence of each element of its system of quality control and retain this documentation such that monitoring reviews can be performed of the firm's compliance with HKSQC1.



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## Documentation

### Documentation of the firm's policies and procedures

- The firm shall develop policies and procedures that specify the level and extent of documentation required in all engagements and for general firm use
- The firm must also establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control
- The policies are often embedded in the firm's engagement templates in the form of standard communications, questionnaires, checklists, and memoranda



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## Documentation

- ❖ HKSA 220 requires that for an audit, documentation must include:
  - issues regarding compliance with ethical requirements and how resolved
  - conclusions on compliance with independence requirements
  - conclusions regarding the acceptance and continuance of client relationships
  - nature and scope of consultations taken when any difficult or contentious matter arises on audit



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## Findings from practice review programme

### 1. General

- The manual - "A Guide to Quality Control" had not been tailored to suit the circumstances of the Practice
- Inconsistencies between the policies and procedures in the manual and those actually applied or procedures set out in the manual not implemented
- Practice introduced quality control policies and procedures just prior to the practice review
- Practice did not ensure subcontractors follow the Practice's manual

### 2. Client acceptance and continuance

- Standard acceptance and continuance checklists from the guide are completed in a cursory manner without giving the "real" issues proper consideration
- Documentation did not demonstrate that a rigorous assessment of client and fraud risk had been carried out



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## Findings from practice review programme

### 3. Engagement quality control review (EQCR)

- Inappropriate scope of review
- Insufficient time of review
- Little evidence of review
- Personnel with insufficient experience and authority was assigned as EQC reviewer

### 4. Rotation of key audit personnel

- Some small practices had not rotated the engagement partner and EQC reviewer for listed engagements after 7 years

### 5. Independence

- Heavy reliance on some listed clients in terms of total fees. No proper disclosures to those charged with governance and no safeguards applied to reduce the threat to an acceptable level



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## Findings from practice review programme

### 6. Monitoring

- 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
- The effectiveness of monitoring reviews was in question as monitors failed to identify significant deficiencies
- No follow-up actions were proposed to address the monitor's findings
- No documentation to support the monitoring review

### 7. File assembly

- No procedures for final assembly of audit files and solely rely on staff self-discipline to handle the filing
- Working papers on significant audit areas (e.g. tests of control, internal consultation memo on key accounting issues) were not in the audit files or archived softcopy



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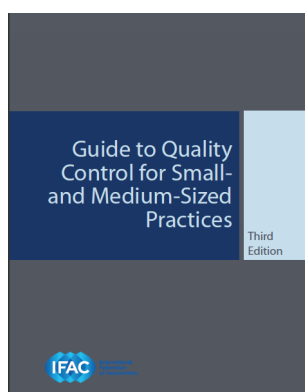
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## Quality control documentation

### Relevant publications

➤ A Guide to Quality Control (HKICPA)

[http://www.hkicpa.org.hk/file/media/section5\\_membership/Membership%20Events/others/Guide-order\\_form.pdf](http://www.hkicpa.org.hk/file/media/section5_membership/Membership%20Events/others/Guide-order_form.pdf)



➤ Guide to Quality Control for Small and Medium-Sized Practices (IFAC)

<http://www.ifac.org/publications-resources/guide-quality-control-small-and-medium-sized-practices-third-edition-0>



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# PART 7

## Engagement performance



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## Engagement performance

### Objectives

Through established policies and procedures,

- the firm requires that **engagement be performed according to professional standards and applicable regulatory and legal requirements.**
- there is reasonable assurance that the firm and its partners and staff adequately and properly plan, supervise and review engagements and **produce engagement reports that are appropriate in the circumstances.**
- HKSA 220 and HKSQC 1 address the requirements on engagement performance.



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# Engagement performance

Topics:

- A. Planning, supervision and review
- B. Consultation
- C. Engagement Quality Control review
- D. Differences of opinion
- E. Engagement Documentation



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# Engagement performance

## A. Planning, supervision and review

- All engagements the firm undertakes must be adequately planned, supervised, and reviewed according to the standards of the profession and the firm.
- The engagement partner remains responsible for the engagement and its performance regardless of any delegation that may take place in order to perform the work necessary to issue the report.
- For smaller engagements, due to the small size of the engagement team, the relative size for planning, supervision and review would be quite simple.



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# Engagement performance

## 1. Planning

In the case of an audit,

- It includes developing an **overall audit strategy** and preparing a **detailed audit approach** to performing an engagement; and
- It allows for the selection of appropriate audit procedures in response to assessed risks of material misstatement, through the design and implementation of appropriate responses to those risks in the context of verifying management's assertions.



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# Engagement performance

## 1. Planning (cont'd)

Factors to consider for planning

- **Any significant issues** that have been identified during the acceptance and continuance review are appropriately addressed;
- The partners and staff selected to work on the engagement are **available, scheduled, and assigned**;
- **Training, business knowledge**, and the necessary research for the engagement are in place;
- **Third-party involvement and the work of specialists** and other service providers are considered and secured;
- **Independence and/or conflict issues** are appropriately addressed or, if problems exist, the client has enough time to seek alternative services; and
- The engagement team is **briefed** to facilitate an understanding of each team member's respective objectives.



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# Engagement performance

## 2. Supervision

Factors to consider

- **Tracking the progress** of the engagement;
- Considering the **competence and capabilities** of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the engagement;
- **Addressing significant matters** arising during the engagement, considering their significance and **modifying the planned approach** appropriately; and
- Identifying matters for **consultation** or consideration by more experienced engagement team members during the engagement.



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# Engagement performance

## 3. Review

**Who?**

- The one which is **sufficiently capable and experiences, and will be delegated by the engagement partner**, who is ultimately responsible for reviewing the work of the engagement team.
- More senior professionals review the work of the less experienced staff.

**When?**

- **Timely review**, especially engagement partner conducts timely reviews of critical areas of judgement, significant risks

**Does engagement partner need to review the entire documentation?**

- No, the engagement partner can choose to do so.
- **Document the extent and timing of review**, e.g. using standardized engagement templates to facilitate the documentation of review



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# Engagement performance

## What do we have to look for when reviewing the files?

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved.



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# Engagement performance

## 4. Consistency in the Quality of Engagement Performance

### How can we ensure consistency in engagement performance?

- Use of written or electronic manuals, software tools or other forms of standardized documentation, and industry or subject matter-specific guidance materials
- Briefing of engagement team to understand the objectives of their work
- Processes for complying with applicable engagement standards
- Processes of engagement supervision, staff training and coaching
- Methods of reviewing the work, the significant judgements made and the form of report being issued
- Appropriate documentation of the work performed and of the timing and extent of the review
- Process to keep all policies and procedures current



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# Engagement performance

## B. Consultation

### What is it?

- Consultation includes discussion at the appropriate professional level, with individuals within or outside the firm who have specialized expertise.
- Consultation helps to promote quality and improves the application of professional judgment. It also helps to promote a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

### Policies and procedures

- Appropriate consultation takes place on **difficult or contentious matters**
- **Sufficient resources** are available to enable appropriate consultation to take place
- **The nature and scope of, and conclusions** resulting from such consultations are documented and are agreed by both the individual seeking consultation and the individual consulted; and
- **Conclusions** resulting from consultations are **implemented**.



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# Engagement performance

## B. Consultation (cont'd)

### When will we need to seek consultation?

- A probable going-concern issue
- Suspected or discovered fraud or other irregularities
- Management integrity
- Need for qualifying the report
- Restatement of prior-year financial statements
- Significant, complex and or new accounting or auditing treatment
- Significant third-party claim against the client and the firm
- Substantial reorganization of the client's business
- A plan to become a listed entity



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# Engagement performance

## B. Consultation (cont'd)

### Reminders

- To ensure effective consultation on significant, ethical and other matters:
  - ✓ Those who are consulted are **given all relevant facts** to be able to provide informed advice and have **appropriate knowledge, seniority and experience**
  - ✓ **Documentation** includes the issues on which consultation was sought and the results of the consultation, e.g. decisions taken, basis of decision and how they were implemented.

### How can it applies to smaller firms?

- Consider advisory services provided by
  - ✓ Other firms;
  - ✓ Professional and regulatory bodies; or
  - ✓ Commercial organisations that provide relevant quality control services

# Engagement performance

## B. Consultation (cont'd)

### External consultation

- Document the followings:
  - ✓ the situation that external consultation is required and authorised by engagement partner
  - ✓ external provider's opinion or positions
  - ✓ external provider's qualifications, relevant competencies, independence and objectivity
  - ✓ course of action recommended
  - ✓ Alternatives, final positions and explanation if the advice is not implemented or more than one consultation is completed
- Observe privacy rights and client confidentiality requirements

## Engagement performance

### Pre-issuance review

### C. Engagement quality control review (EQCR)

The firm shall establish policies and procedures requiring for appropriate engagements, an engagement quality review that provides an objective evaluation, on or before the date of the report, of the significant judgements made by the engagement team and the conclusions reached in formulating the report

#### General policies and procedures

- Require an EQCR for all audits of financial statements of **listed entities**
- **Set out criteria** against which all other audits and reviews of historical financial information and other assurance and related services engagements shall be evaluated to determine whether an EQCR should be performed
- Require an EQCR **for all engagements**, if any, **meeting the criteria** set



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## Engagement performance

### C. Engagement quality control review (EQCR)

#### Criteria for determining when to have an EQCR

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.
- Example:

	An EQCR is required for all audit engagements where:
BP	<ul style="list-style-type: none"><li>a) The entity has more than 25 stakeholders, partners, investors or beneficiaries who rely on the engagement report;</li><li>b) The total of fees billed [for assurance work] exceeds a specified threshold [such as \$15,000] or a specified percentage [such as 10-15%] of the partner's or Firm's gross revenues;</li><li>c) The entity has been assessed as high risk [such as on the Engagement Risk Assessment Worksheet found in Appendix D of this manual]; or</li></ul>
	<ul style="list-style-type: none"><li>d) It is required as a safeguard in response to a familiarity threat, such as that addressed in Policy 4.7.</li></ul>
	An EQCR is not required for review engagements unless (in the opinion of the managing partner or engagement quality leader) the engagement is unusually large or poses a high risk to the Firm. [Insert Firm's definition of large and high risk. Refer to Appendix D of this manual.]

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# Engagement performance

## C. Engagement quality control review (EQCR)

### Policies and procedures setting out nature, timing and extent of EQCR

#### Timing

- Involve early in the engagement process
- Engagement partner must review the file before an EQCR
- The engagement report cannot be dated until the completion of the EQCR, including resolving all issues raised, completing appropriate discussion and implementation of any issues

#### Extent

- Discussion of significant matters with the engagement partner
- Review of the financial statements or other subject matter information and the proposed report
- Review of selected documentation relating to significant judgements the engagement team made and the conclusions reached
- Evaluation of the conclusion reached in formulating the report and consideration of whether the proposed report is appropriate

# Engagement performance

## C. Engagement quality control review (EQCR)

### Policies and procedures setting out nature, timing and extent of EQCR

#### Extent for listed entities

- The engagement team's evaluation of the firm's **independence** in relation to the specific engagement;
- Whether appropriate **consultation** has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions, arising from those conclusions; and
- Whether documentation selected for review reflects the work performed in relation to **significant judgements** and supports the conclusion reached.

Other matters include:

- Significant risks identified and the responses to those risks
- Judgements made with respect to materiality and significant risks
- The significance and disposition of corrected and uncorrected misstatements
- Matters to be communicated to management, TCWG and regulatory bodies

# Engagement performance

## C. Engagement quality control review (EQCR)

### Criteria for the Eligibility of engagement quality control reviewers

- **Technical qualifications** required to performed the role, including the necessary **experience and authority**
- Degree to which an EQC reviewer can be consulted on the engagement without compromising **the reviewer's objectivity**
- Maintain the objectivity of the EQC reviewer, e.g. the EQC reviewer:
  - ✓ Where practicable, is not selected by the engagement partner;
  - ✓ Does not otherwise participate in the engagement during the period of review;
  - ✓ Does not make decisions for the engagement team; and
  - ✓ Is not subject to other considerations that would threaten the reviewer's objectivity.
- Provide replacement of the EQC reviewer when the reviewer's ability to perform an objective review may be impaired.

# Engagement performance

## C. Engagement quality control review (EQCR)

### Documentation of the EQCR

- The procedures required by the firm's policies on EQCR have been performed;
- The EQCR has been completed on or before the date of the report; and
- The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgements the engagement team made and the conclusions it reached were not appropriate.



# Engagement performance

## D. Differences of opinion

The firm shall establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the EQC reviewer.

### Examples

- Differences of opinion on interpretations and applications of HKFRSs and HKSAs;
- Differences of opinion on ethics-related matters and/or the requirements in the Code of Ethics
- Disagreements on the economic substance of a transaction or series of transactions, or the levels of detail required in the documentation for engagement files;
- Differences of opinion resulting from the engagement and quality control review process;
- Change and resistance to change in firm practices, policies, and structures; and
- Differences of opinion on the suitability and competencies of engagement personnel.

# Engagement performance

## D. Differences of opinion

### Policies and procedures

- Identification of differences of opinion at an early stage
- Clear guidelines to the successive steps to be taken thereafter
- Conclusions reached be documented and implemented; and
- The report not be dated until the matter is resolved.

### Suggested policy

- Consideration of all relevant facts and the reasons for the difference of opinion
- Consideration of all available research material
- Consideration of the views of senior partners and staff within the firm
- Consideration of the views with another firm, or a professional or regulatory body
- Mediation between the parties to determine whether concurrence can be obtained

# Engagement performance

## E. Engagement documentation

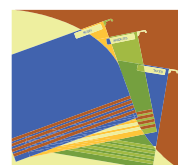
Policies and procedures on:

- (a) Completion of the assembly of final engagement files on a timely basis after the engagement reports have been finalised.
- In the case of audit, the time limit would ordinarily not be more than 60 days after the date of the auditor's report.
  - Law or regulation may prescribe the time limits for specific types of engagements.

Questions: How about the situation where two or more different reports are issued in respect of the same entity, e.g. one for group reporting and one for statutory purpose?



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# Engagement performance

## E. Engagement documentation

Policies and procedures on:

- (b) **Maintain confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation**
- Consider the relevant ethical requirements, legal or professional duty, laws and regulations
  - Below are some suggested controls that the firms can design and implement:

To prevent unauthorised alteration or loss of engagement documentation:

- Enable the determination of when and by whom engagement documentation was created, changed or reviewed;
- Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via the Internet;
- Prevent unauthorized changes to the engagement documentation; and
- Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.



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# Engagement performance



## E. Engagement documentation

Policies and procedures on:

- (b) **Maintain confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation (cont'd)**

### Others:

- The use of a password among engagement team members to restrict access to electronic engagement documentation to authorized users.
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement.
- Procedures for properly distributing engagement documentation to the team members at the start of the engagement, processing it during engagement, and collating it at the end of engagement.
- Procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation.
- Generate scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
- Integrate the scanned copies into the engagement files, including indexing and signing off on the scanned copies as necessary; and
- Enable the scanned copies to be retrieved and printed as necessary.

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# Engagement performance



## E. Engagement documentation

Policies and procedures on:

- (c) Retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation

Consider the following factors when determining the period:

- Any needs to provide record of matters of continuing significance to future engagements?
- Any local law or regulation prescribes specific retention periods for certain types of engagements?
- Any generally accepted retention periods where there are no specific legal or regulatory requirements?

HKSQC1. A61

In the specific case of audit engagements, the retention period would **ordinarily no shorter than five years from the date of the auditor's report**, or if later, the date of the group auditor's report.



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# Engagement performance

## E. Engagement documentation

Policies and procedures on:

- (c) Retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation (cont'd)

Other factors on the policies and procedures:

- Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation since the underlying technology may be upgraded or changed over time;
- Provide, where necessary, a record of changes made to engagement documentation after the engagement files have been completed; and
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.



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# PART 8 Monitoring



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# Monitoring

## Objectives

The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to professional standards and applicable legal and regulatory requirements;
- Whether the system of quality control has been appropriately designed and effectively implemented; and
- Whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.



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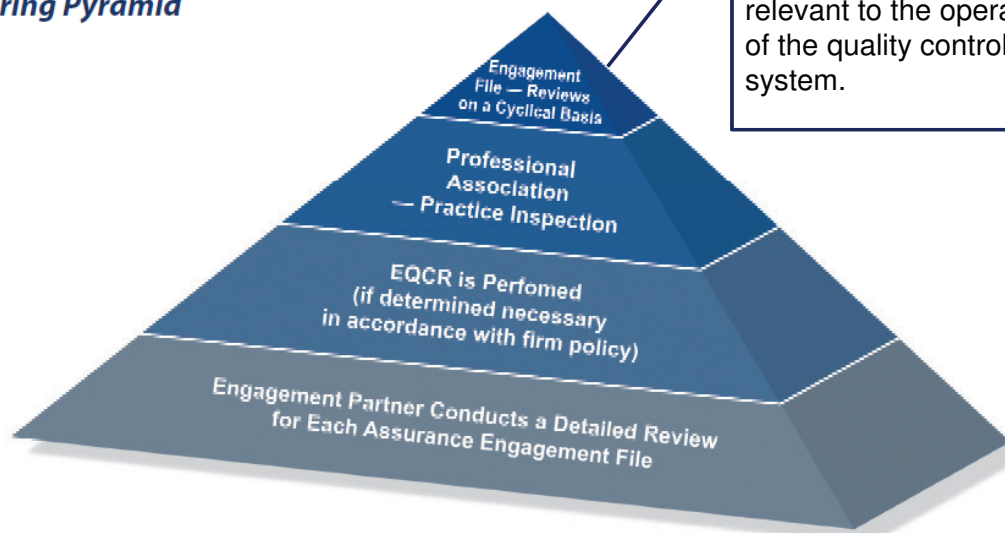
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# Monitoring

## Differences between EQC review and monitoring

### Monitoring Pyramid



Monitoring consists primarily of understanding control system and determining, through interviews, walk-through tests, and inspections of engagement files and other documentation relevant to the operation of the quality control system.



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# Monitoring

## Process

HKSQC 1 .48 Monitoring process must:

- a) Include an **ongoing consideration and evaluation** of the firm's system of quality control including, **on a cyclical basis, inspection of at least one completed engagement for each engagement partner**;
- b) Require responsibility for the monitoring process to be assigned to **a partner or partners or other persons with sufficient and appropriate experience and authority** in the firm to assume that responsibility; and
- c) Require that those performing the **engagement** or the **engagement quality control review** are **not involved in inspecting the engagement**.



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# Monitoring

## Process

- (a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner

1. What is an ongoing consideration and evaluation of quality control system?

This includes an analysis of:

- New developments in professional standards and applicable legal and regulatory requirements, and how they are reflected in the firm's policies and procedures where appropriate;
- Written confirmation of compliance with policies and procedures on independence;
- Continuing professional development, including training;
- Decisions related to acceptance and continuance of client relationships and specific engagements.



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# Monitoring

## Process

- (a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner

1. What is an ongoing consideration and evaluation of quality control system?  
(cont'd)

This includes an analysis of:

- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.
- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.
- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures



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# Monitoring

## Process

- (a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner.

2. Does the standard specify how long for the cycle?

The standard suggests a cycle that spans not more than three years.

Other factors that we need to consider includes:

- The size of the firm.
- The number and geographic location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.



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# Monitoring

## Process

### Reminders:

- This monitoring function applies to all Practices and there is no exemption on the grounds of size or nature of client base
- For smaller firms with a limited number of persons,
  - ✓ use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures.
  - ✓ Establish arrangements to share resources with other appropriate organisations
- For sole practitioners who find it difficult to share resources and there is no other alternatives, self-monitoring may be possible if they can manage to perform the monitor role objectively. However, there are clear limitations in the effectiveness of self-review.



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# Monitoring

## Process

### Reminders (cont'd)

- Make sure it cover both a review of compliance with the practice's overall quality control policies and procedures and "completed" audit engagement file reviews
- Selection of engagements:
  - ✓ Select high risk clients, e.g. listed and regulated clients
  - ✓ individual engagements without prior notification to the engagement team
- Take into account the scope or conclusions of an independent external inspection program



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# Monitoring

## Process

### Reminders (cont'd)

- Document properly the inspection:

- An evaluation of adherence to professional standards and applicable regulatory and legal requirements;
- The results from evaluating elements of the quality control system;
- An evaluation of whether the firm has appropriately applied quality control policies and procedures;
- An evaluation of whether the engagement report is appropriate in the circumstances;
- Identification of any deficiencies, the underlying reasons why they arose, their effect, and a decision on whether further action is necessary, describing this action in detail; and
- A summary of results and conclusions reached (provided to the firm), with recommendations for corrective actions or changes needed.



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# Monitoring

## Evaluating, communicating and remedying identified deficiencies

### 1. Determine whether the effect of deficiencies noted are either:

- Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and applicable legal and regulatory requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or
- **Systemic, repetitive or other significant deficiencies** that require prompt corrective action.

### 2. Communicate to relevant engagement partners and other appropriate personnel deficiencies noted and recommendations for appropriate remedial action.



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# Monitoring

## Evaluating, communicating and remedying identified deficiencies

### 2. Communicate to relevant engagement partners and other appropriate personnel deficiencies noted and recommendations for appropriate remedial action. (Cont'd)

Recommendations include one or more of the followings:

- a) Taking appropriate remedial action in relation to an individual engagement or member of personnel;
- b) The communication of the findings to those responsible for training and professional development;
- c) Changes to the quality control policies and procedures; and
- d) Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.



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# Monitoring

## Evaluating, communicating and remedying identified deficiencies

### 3. Establish policies and procedures to address cases where the results of the monitoring procedures indicate that a report may be inappropriate or that procedure were omitted during the performance of the engagement

This includes:

- Require the firm to determine what further action is appropriate to comply with relevant professional standards and applicable legal and regulatory requirements
- Consider whether to obtain legal advice



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# Monitoring

## Evaluating, communicating and remedying identified deficiencies

### 4. Required communications

- Purpose?** Take prompt and appropriate action in accordance with their defined roles and responsibilities
- To whom?** Engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer or its managing board of partners
- When?** At least annually
- What?**
- (a) A description of the monitoring procedures performed.
  - (b) The conclusions drawn from the monitoring procedures.
  - (c) Where relevant, a description of systemic, repetitive or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.



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# Monitoring

## Evaluating, communicating and remedying identified deficiencies

### 5. Monitoring procedures implement on a network firm basis

- a) **At least annually**, the network communicate the **overall scope, extent and results** of the monitoring process to appropriate individuals within the network firms; and
- b) The network communicate promptly any identified deficiencies in the system of quality control to appropriate individuals within the relevant network firm or firms so that the necessary action can be taken,

in order that engagement partners in the network firms can rely on the results of the monitoring process implemented within the network, unless the firms or the network advise otherwise.



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# Monitoring

## Complaints and allegations

### Policies and procedures

- To handle appropriately
  - a) Complaints and allegations that the work performed by the firm fails to comply with professional standards and applicable legal and regulatory requirements; and
  - b) Allegations of non-compliance with the firm's system of quality control.

Firm should consider all of the functions that are required in order to deal with complaints and allegations, for example:

- Maintaining all complaint and allegation policies;
- Receiving all reports that relate to complaints and allegations;
- Providing guidance and consultation on complaint and allegation matters to those who serve in a supervisory capacity;
- Providing documentation on these matters, including receipt of the complaint, findings of the investigation, and final outcome;
- Reporting to the complainant; and
- Conducting or providing supervision for all investigations.



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# Monitoring

## Complaints and allegations

### Policies and procedures

- Establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals
- The partner supervising the investigation:
  - ✓ Has sufficient and appropriate experience;
  - ✓ Has authority within the firm; and
  - ✓ Is otherwise not involved in the engagement.
  - ✓ Consider involve legal counsel



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# Monitoring

## Complaints and allegations

### Deficiencies noted in

- design or operation of the firm's quality control policies and procedures
- non-compliance with the firm's system of quality control by an individual or individuals

### Appropriate actions

- a) Taking appropriate remedial action in relation to an individual engagement or member of personnel;
- b) The communication of the findings to those responsible for training and professional development;
- c) Changes to the quality control policies and procedures; and
- d) Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.



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## PART 9

# Recap on audit completion and quality control



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# Recap on audit completion and quality control

## Questions

1. Which of the followings are the purposes of performing final analytical procedures?
  - a. To identify a previously unrecognised risk of material misstatement
  - b. To obtain audit evidence to address risks at assertion level
  - c. To assist in arriving at the overall conclusion as to the reasonableness of the financial statements



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# Recap on audit completion and quality control

## Questions

2. Which of the followings are considered to be material misstatements that have to be adjusted?
  - a. Misstatements that are smaller than the clearly trivial
  - b. Misstatements that affect the compliance of debt covenants
  - c. Misstatements that are immaterial but could be significant in future due to the selection of an incorrect accounting policy
  - d. Misstatements that increase management compensation



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## Recap on audit completion and quality control

### Questions

3. Which of the following statement about audit opinion is incorrect under the relevant auditing standards?
- a. An "other matter" paragraph is added to highlight important matters already disclosed in the financial statements that will enhance the users understanding of the financial statements.
  - b. "Emphasis of matter" and "Other matter" paragraphs are not modifications to the audit opinion.
  - c. If there are limitations imposed by management such that the auditor is unable to obtain sufficient appropriate evidence and the possible effects on the financial statements of undetected misstatements are both material and pervasive, a disclaimer of opinion would be appropriate.
  - d. If the financial statements are materially misstated due to selection of an inappropriate accounting policy which affects one account balance only, a qualified opinion would be appropriate.



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## Recap on audit completion and quality control

### Questions

4. Which of the following statements about communicating with those charged with governance are correct under HKSA 260 and 265?
- a. The auditor is required to determine the appropriate person(s) within the entity's governance structure with whom to communicate matters of governance interest, i.e. those charged with governance.
  - b. Auditor of listed entities should communicate with those charged with governance about independence matters, such as the total fees charged for audit and non-audit services, safeguards applied, etc.
  - c. The auditor has to communicate all significant deficiencies in internal control to those charged with governance in writing.
  - d. For all deficiencies that were reported in prior audit, the auditor does not need to repeat the communication in the current year.



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## Recap on audit completion and quality control

### Questions

5. Which of the following statements about management representations under HKSA 580 are correct?
- a. The date of written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.
  - b. Written management representations can be used as the sole source of audit evidence on significant audit matters.
  - c. 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.
  - d. If the auditor concludes that there is sufficient doubt about the integrity of management such that the required written representations are not reliable, the auditor would disclaim an opinion on the financial statements.



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## Recap on audit completion and quality control

### Questions

6. Are the following statements true or false?

#### Statement 1

According to HKSQC 1, the firm must assign an engagement quality control reviewer for all audits of financial statements of listed entities.

#### Statement 2

The engagement quality control reviewer provides an objective evaluation of the significant judgements made by the engagement team and the conclusions reached after the auditor's report has been issued.



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# Recap on audit completion and quality control

## Questions

7. Are the following statements true or false?

### Statement 1

Monitoring process includes ongoing evaluation of the firm's quality control system and inspection of at least one completed engagement for each engagement partner on a cyclical basis.

### Statement 2

Monitoring applies to all practices. There is no exemption on the grounds of size or nature of client base.



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# Recap on audit completion and quality control

## Questions

8. Are the following statements true or false?

### Statement 1

According to HKSQC 1, the time limit for the completion of the assembly of audit engagement files would ordinarily not be more than 60 days after the date of the financial statements.

### Statement 2

Firm should set up policies and procedures on maintaining the confidentiality, safe custody, integrity, accessibility and irretrievability of engagement documentation.



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# Thank you for your attention

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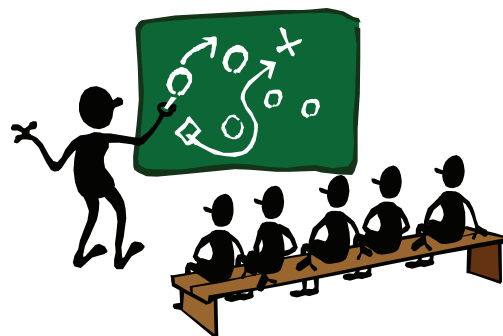
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Presented by : Winnie Chan, Associate Director, Technical Learning and Support, HKICPA

Eky Liu, Manager, Technical Learning and Support, HKICPA

Venue: The Hong Kong Institute of Certified Public Accountants

# ***A Refresher Course on Current Auditing Standards 2013 (Day 5)***



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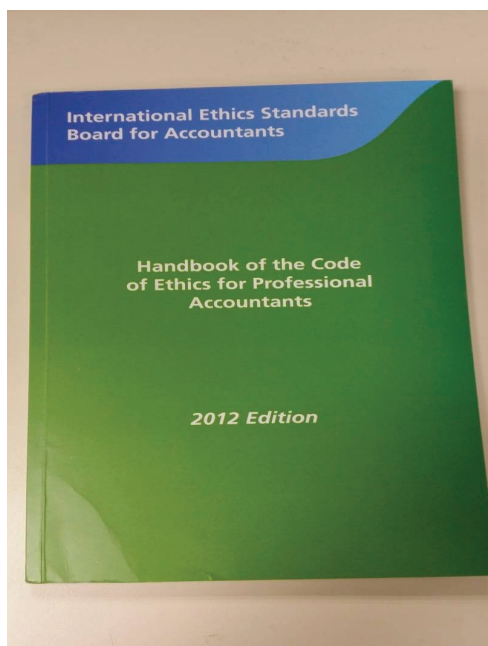
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*International Ethics  
Standards Board for  
Accountants:*

*Handbook of the Code of  
Ethics for Professional  
Accountants*



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# Ethics Circular 1- Guidance for Small and Medium Practitioners on the Code of Ethics for Professional Accountants



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EC 1  
December 2014 Revised November 2013

*Ethics Circular 1*

## Guidance for Small and Medium Practitioners on the Code of Ethics for Professional Accountants

This revised Ethics Circular 1 was endorsed by the Institute's Ethics Committee in October 2013 and supersedes the Ethics Circular 1 previously issued in December 2011. This Ethics Circular does not constitute an ethics standard and is issued with the intent to provide guidance in order to assist small and medium practitioners including sole proprietors, on their adoption of the Code on the provision of non-assurance services and other topical issues to an audit client without modifying the requirements as set out in the Code. Professional judgment should be used by members in its application. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this Ethics circular can be accepted by the Institute.



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## Agenda

- Part A - Introduction
- Part B - Fundamental Principles
- Part C - Common Questions by SMPs
- Part D - Current Development



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# Part A

## Introduction



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## Convergence with IESBA Code

- The Institute has determined to **adopt the IESBA Code of Ethics** for Professional Accountants issued by the IFAC International Ethics Standards Board of Accountants (IESBA) **as the ethical requirements for its members**

## Additional local application (Part D)

- In addition to the IESBA Code, the **HKICPA Code of Ethics for Professional Accountants (the Code)** has an additional **Part D** which are either local application or represent an amplification of provisions in the IESBA Code



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## Requirement to members

- Council requires members of the Institute to comply with the Code
  - Apparent failures by members of the Institute to comply with the Code are liable to be enquired into by the appropriate committee established under the authority of the Institute, and **disciplinary action** may result
  - Disciplinary action may include an order that the name of the **member be removed from the Institute's membership register**
  - The Code of Ethics is likely to be taken into account when the work of members of the Institute is being considered in a court of law or in other contested situations



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## Part B

# Fundamental Principles



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## Structure of the Code of Ethics

The Code of Ethics contains four parts

### Part A

- **Part A** - establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework that professional accountants shall apply to:
  - **Identify threats** to compliance with the fundamental principles;
  - **Evaluate** the significance of the threats identified; and
  - **Apply safeguards**, when necessary, to eliminate the threats or reduce them to an acceptable level
  - A professional accountant shall **use professional judgment** in applying this conceptual framework



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## Structure of the Code of Ethics

### Part B, C and D

- (100.3)
  - Parts B, C and D describe how the conceptual framework applies in certain situations
  - They provide **examples of safeguards** that may be appropriate **to address threats** to compliance with the fundamental principles
  - They also describe situations where **safeguards are not available** to address the threats, and consequently, the **circumstance or relationship creating the threats shall be avoided**



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## Structure of the Code of Ethics

- **Part B** applies to professional accountants in public practice
- **Part C** applies to professional accountants in business
  - Professional accountants in public practice may also find Part C relevant to their particular circumstances
- **Part D** sets out additional ethical requirements on specific areas



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## Fundamental Principles (100.5)

- A professional accountant shall comply with the following fundamental principles:
  - **Integrity** – to be straightforward and honest in all professional and business relationships
  - **Objectivity** – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments
  - **Professional Competence and Due Care** – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards



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## Fundamental Principles (100.5)

- **Confidentiality** – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties
- **Professional Behavior** – to comply with relevant laws and regulations and avoid any action that discredits the profession
- Each of these fundamental principles is discussed in more detail in Sections 110–150 of the Code of Ethics



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## Conceptual Framework Approach (100.6 to 100.11)

- The circumstances in which professional accountants operate may create specific threats to compliance with the fundamental principles
  - It is impossible to define every situation that creates threats to compliance with the fundamental principles and specify the appropriate action
  - Therefore, the Code of Ethics establishes a **conceptual framework** that requires a professional accountant to identify, evaluate, and address threats to compliance with the fundamental principles



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## Conceptual Framework Approach (100.6 to 100.11)

- ***Threats identification and evaluation***

When a professional accountant identifies threats to compliance with the fundamental principles and, based on an evaluation of those threats, determines that they are **not at an acceptable level**, the professional accountant shall determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level



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## Conceptual Framework Approach (100.6 to 100.11)

- ***"Reasonable and informed third party" test***

In making that determination, the professional accountant shall exercise professional judgment and take into account whether a **reasonable and informed third party**, weighing all the specific facts and circumstances available to the professional accountant at the time, would be **likely to conclude** that the **threats would be eliminated or reduced to an acceptable level by the application of the safeguards**, such that compliance with the fundamental principles is not compromised



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## Conceptual Framework Approach (100.6 to 100.11)

- ***"Reasonably be expected to know" test***

A professional accountant shall **evaluate any threats to compliance with the fundamental principles** when the professional accountant knows, or could reasonably be expected to know, of circumstances or relationships that may compromise compliance with the fundamental principles



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## Conceptual Framework Approach (100.6 to 100.11)

- ***Qualitative consideration***

A professional accountant shall take **qualitative** as well as **quantitative factors** into account when evaluating the significance of a threat

- ***When threats cannot be eliminated or reduced to an acceptable level***

In such situations, the professional accountant shall **decline or discontinue** the specific professional service involved or, when necessary, resign from the engagement (in the case of a professional accountant in public practice) or the employing organization (in the case of a professional accountant in business)



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## Threats and Safeguards (100.12 to 100.16)

- Threats may be created by a broad range of relationships and circumstances
  - When a relationship or circumstance creates a threat, such a threat could compromise, or could be perceived to compromise, a professional accountant's compliance with the fundamental principles
  - A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle



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## Threats and Safeguards (100.12 to 100.16)

- Threats fall into one or more of the following 5 categories:
  - **Self-interest threat** — the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior
  - **Self-review threat** — the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service



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## Threats and Safeguards (100.12 to 100.16)

- **Advocacy threat** — the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised
- **Familiarity threat** — the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work



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## Threats and Safeguards (100.12 to 100.16)

- **Intimidation threat** — the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant
- Parts B and C of this Code explain how the categories of threats may be created for professional accountants in public practice and professional accountants in business, respectively
  - Professional accountants in public practice may also find Part C relevant to their particular circumstances



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## Threats and Safeguards (100.12 to 100.16)

- Safeguards are actions or other measures that may eliminate threats or reduce them to an acceptable level
- Parts B and C of the Code of Ethics discuss safeguards in the work environment for professional accountants in public practice and professional accountants in business, respectively



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## Part C Common Questions by SMPs



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## Common Questions by SMPs

- The common questions on the Code raised by Small and Medium Practitioners include the followings:
  - Identification of **public interest entities** (Part 1)
  - provision of **company secretarial services** to audit clients (Part 2)
  - provision of **accounting services** – preparing accounting records and financial statements for audit clients (Part 3)
  - provision of **taxation services** for audit clients (Part 4)



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## Consideration for providing non-assurance services



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## Consideration for providing non-assurance services

### ***Pre-acceptance evaluation***

- Members are reminded that under paragraph 290.158 of the Code a determination shall be made as to whether providing a non-assurance service would create a threat to independence **before** the firm accepts an engagement to provide such service to an audit client
  - If a threat is created that cannot be reduced to an acceptable level by the application of safeguards, the non-assurance service shall not be provided



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## Consideration for providing non-assurance services

### ***Service specific evaluation***

- Based on the above, firms should evaluate the significance of the threats created by the particular non-assurance service in order to evaluate whether safeguards need to be applied or what safeguards are to be applied
  - It is possible to have circumstances where safeguards are not required given the relevant threats created by the particular non-assurance service are not significant



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## Consideration for providing non-assurance services

### ***Documentation and explanation***

- Practitioners are expected to document and to explain the relevant facts and circumstances and the determination on the "threats and safeguards" evaluation
  - As is the case whenever professional judgment is exercised auditors must be prepared to explain the basis for their decision or conclusion and be prepared to defend it against challenges from third parties including regulators



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## Identification of Public Interest Entities



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# Identification of Public Interest Entities

## **Definition**

- Public interest entities, for the purpose of auditor independence, is defined in paragraph 290.25 of the Code to include:
  - all listed entities; and
  - any entity (a) defined by regulation or legislation as a public interest entity or (b) for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator



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# Identification of Public Interest Entities

## **Identification of additional PIE**

- Paragraph 290.26 of the Code further **encourages the firms to determine** whether to treat additional entities, or certain categories of entities, as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered include:
  - the **nature** of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders. Examples may include financial institutions, such as banks and insurance companies, and pension funds;
  - **size**; and
  - **number of employees**



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## Identification of Public Interest Entities

- It is also stated in footnote 1b of the Code that currently under the legislation of Hong Kong, there is **no definition of public interest entity or requirement for audit of an entity to be conducted with the same independence requirements applicable to the audit of listed entities**
  - Therefore auditors have to review their own client base and determine whether any clients, other than listed entities, should be treated as public interest entities



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## Identification of Public Interest Entities

- Some practitioners have expressed their concerns on the practical application of paragraph 290.26 of the Code. While there are some broad guiding principles within paragraph 290.26 there are **no mandated criteria** for identification of public interest entities
  - It is possible for different practitioners to make different determinations based on different facts and circumstances
  - However, it is important for practitioners to **document** and to be able to **explain** the thought process that they have gone through and judgments involved in considering whether any of their clients are public interest entities



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## PIE determination on non-listed companies



Does the Code require any non-listed companies to be public interest entities?

- For the purpose of the Code, a **non-listed company is not a public interest entity** unless the firm considers it to be a public interest entity based on professional judgment in accordance with paragraph 290.26 of the Code



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## In-house criteria for PIE determination



Is it a must for practice units to establish their in-house criteria to determine public interest entities under paragraph 290.26 of the Code?

- Paragraph 290.26 of the Code **encourages** the firms to determine whether to treat additional entities, or categories of entities, as public interest entities on the basis that they have a large number and wide range of stakeholders
- Whilst each case should be considered based on its own merits, practice units may consider establishing appropriate in-house criteria in order to ensure consistency in the determination of public interest entities under paragraph 290.26 of the code



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## In-house criteria for PIE determination



Are securities firms considered as public interest entities?

- Both the Code and the legislation of Hong Kong do not contain requirement to include securities firms to be public interest entities
- **A securities firm is not a public interest entities unless the firm considers it to be a public interest entity based on professional judgment in accordance with paragraph 290.26 of the Code**



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## PIE determination on subsidiaries of listed entities



There are many private company subsidiaries of listed companies in Hong Kong that engage SMPs as their auditors but the listed companies do not engage the SMPs as their group auditors

The concern is whether auditors of subsidiaries of listed companies, who are not the group auditors, are required to comply with the more stringent requirements of the Code that apply to public interest entities

Is a subsidiary of a listed entity considered to be a public interest entity?



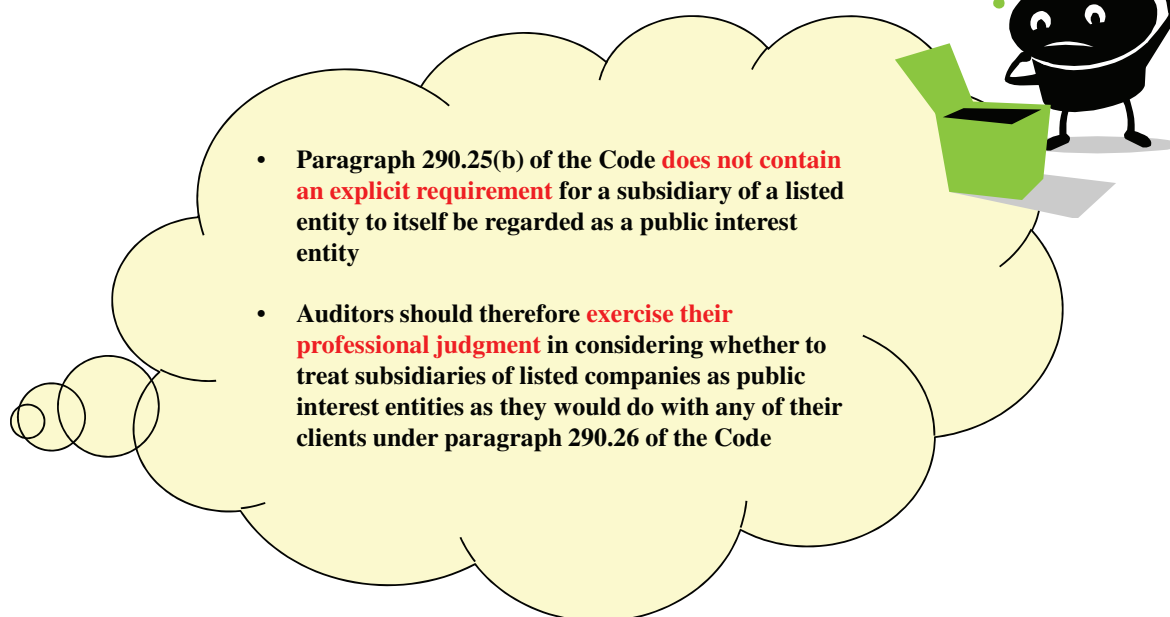
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## PIE determination on subsidiaries of listed entities (cont'd)

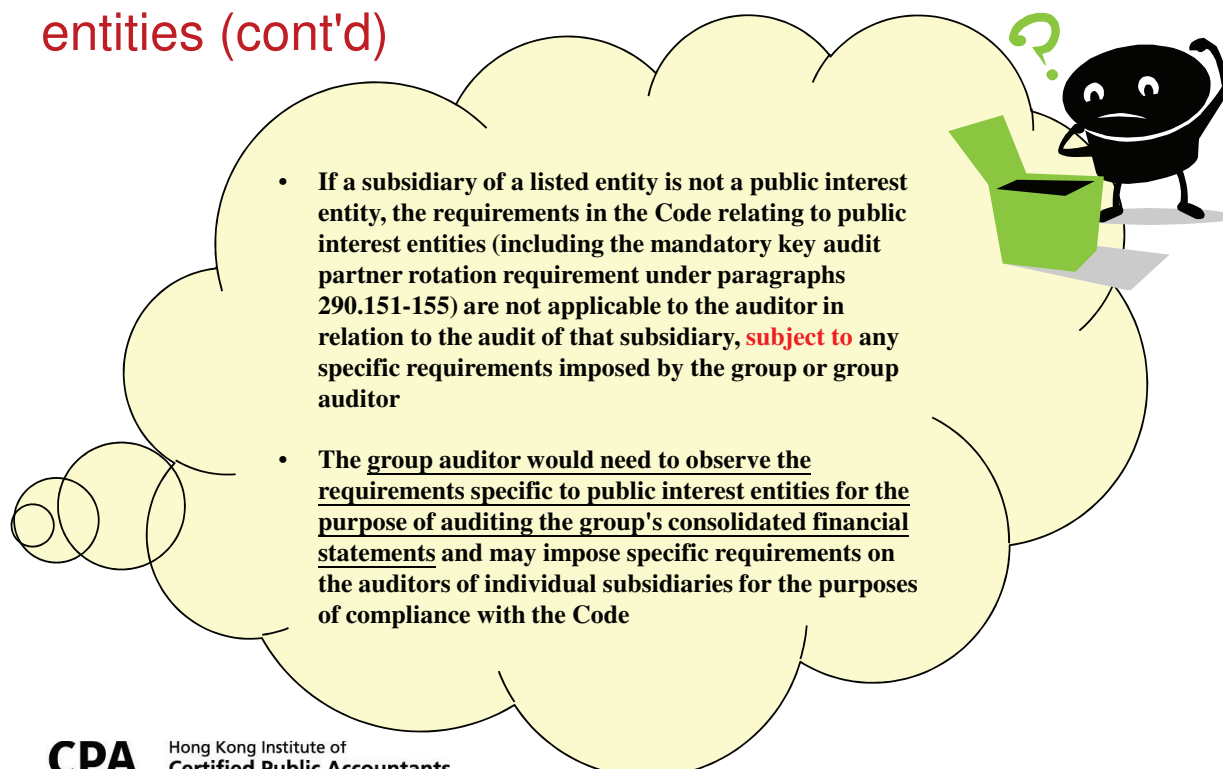


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## PIE determination on subsidiaries of listed entities (cont'd)



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# Provision of company secretarial services to audit clients



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## Provision of company secretarial services to audit clients

***For all audit clients, including public interest entities and non-public interest entities***

- Paragraph 290.146 of the Code states that if a partner or employee of the firm serves as a director or officer of an audit client, the **self review and self-interest threats** created would be so significant that no safeguards could reduce the threats to an acceptable level
  - Accordingly, no partner or employee shall serve as director or officer of an audit client



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## Provision of company secretarial services to audit clients

- Paragraphs 290.147 and 291.136 of the Code explain that the position of company secretary has different implications in different jurisdictions
  - **Duties may range** from administrative duties, such as personnel management and the maintenance of company records and registers, to duties as diverse as ensuring that the company complies with regulations or providing advice on corporate governance matters
  - Generally, this position is seen to imply a close association with the entity



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## Provision of company secretarial services to audit clients

- Paragraph 290.148 of the Code states that if a partner or employee of the firm or a network firm serves as company secretary for a financial statement audit client the **self-review and advocacy threats** created would generally be so significant that no safeguards could reduce the threats to an acceptable level **unless the duties and functions undertaken are limited to those of a routine and formal administrative nature such as the preparation of minutes and maintenance of statutory returns, and are permitted by law**



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## Provision of company secretarial services to audit clients

- Paragraphs 290.149 and 291.138 of the Code further clarify that **performing routine administrative services to support a company secretarial function or providing advice in relation to company secretarial administration matters does not generally create threats to independence, as long as client management makes all relevant decisions**
- Furthermore, partners and staff cannot act as officers of an audit client under the requirements of the Companies Ordinance, which is set out in Statement 1.303 "General Guidance – Restrictions on Appointments as Secretaries and Directors of Audit Clients". Statement 1.303 can be accessed at Volume I of the Institute's Members Handbook  
[http://app1.hkicpa.org.hk/ebook/HKSA\\_Members\\_Handbook\\_Mas ter/volumeI/1\\_303.pdf](http://app1.hkicpa.org.hk/ebook/HKSA_Members_Handbook_Mas ter/volumeI/1_303.pdf)



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## Partner or employee acting as the company secretary of an audit client



**The firm audits the financial statements of its client.**

**The client expects a partner or an employee of the firm or a network firm to serve as the client's company secretary.**

**Is it permissible for a partner or an employee of the firm or a network firm to serve as the audit client's company secretary in this situation?**



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## PIE determination on subsidiaries of listed entities (cont'd)



- As guided by paragraph 290.148 of the Code, a partner or an employee of the firm or a network firm is only permissible to serve as company secretary of the audit client only when:
  - **fulfilling the relevant legal requirement** (i.e. the Hong Kong Companies Ordinance disallows an individual to concurrently hold the posts of auditor and secretary to a company);
  - The duties and functions undertaken are **limited to those of a routine and formal administrative nature** such as the preparation of minutes and maintenance of statutory returns; and
  - Management of client makes all relevant decisions and the **practitioners do not assume any management responsibilities** or make any management decisions.



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## Provision of routine administrative services to support the company secretary



The firm audits the financial statements of its client.

No partner or employee of the firm or a network firm serves as the company secretary of that audit client.

Is it permissible for a partner or an employee of the firm or a network firm to perform routine administrative services to support the company secretary function of the client in this situation?

- Under paragraph 290.149 of the Code, performing routine administrative services to support a company secretarial function or providing advice in relation to company secretarial administration matters **does not generally create threats to independence as long as client management makes all relevant decisions.**



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## Formation of a separate company secretarial company by a sole proprietor practicing member



A sole proprietor practicing member owns a separate company secretarial company and that company secretarial company is appointed as the company secretary of an entity.

Is it permissible for that sole proprietor practicing member be appointed as the auditor of the concerned entity in this situation?



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## Formation of a separate company secretarial company by a sole proprietor practicing member (cont'd)

A black cartoon character with a large head and small body is sitting on a green square. It has a question mark above its head, indicating it is thinking or confused.

- Such structure is **not disallowed under the Hong Kong Companies Ordinance**, which only disallows an individual to concurrently hold the posts of auditor and secretary to a company
- However, practitioners should still follow the other criteria, including
  - **fulfilling the relevant legal requirement** (i.e. the Hong Kong Companies Ordinance disallows an individual to concurrently hold the posts of auditor and secretary to a company);
  - The duties and functions undertaken are **limited to those of a routine and formal administrative nature** such as the preparation of minutes and maintenance of statutory returns; and
  - Management of client makes all relevant decisions and the **practitioners do not assume any management responsibilities** or make any management decisions.



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## Formation of a separate company secretarial company by a sole proprietor practicing member (cont'd)



- Practitioners would also need to be mindful that the separate company secretarial company may qualify to be a network firm of the sole proprietor practicing member due to the common ownership arrangement and therefore the independence requirements under the Code applies to the sole proprietor practicing member also applies to the company secretarial company.



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## Provision of accounting services – preparing accounting records and financial statements for audit clients



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## Provision of accounting and bookkeeping services to audit clients

- Paragraph 290.168 of the Code states that providing an audit client with accounting and bookkeeping services, such as preparing accounting records or financial statements, creates a **self-review threat** when the firm subsequently audits the financial statements.



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## Provision of accounting and bookkeeping services to audit clients

### ***Audit clients who are not public interest entities***

- Paragraph 290.171 of the Code states that firms may provide services related to the preparation of accounting records and financial statements to an audit client that is not a public interest entity where the services are of a **routine or mechanical nature**, so long as any self-review threat created is reduced to an acceptable level
- Examples** of such services include:
  - providing payroll services based on client-originated data;
  - recording transactions for which the client has determined or approved the appropriate account classification;



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## Provision of accounting and bookkeeping services to audit clients (cont'd)

- posting transactions coded by the client to the general ledger;
- posting client-approved entries to the trial balance; and
- preparing financial statements based on information in the trial balance.



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## Provision of accounting and bookkeeping services to audit clients (cont'd)

- In all cases, the **significance of any threat** created shall be evaluated and **safeguards** applied when necessary to eliminate the threat or reduce it to an acceptable level
- **Examples** of such safeguards include:
  - arranging for such services to be performed by an individual who is not a member of the audit team; or
  - if such services are performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the work performed.



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## Provision of accounting and bookkeeping services to audit clients (cont'd)

- It is possible to have circumstances that relevant threat is at an acceptable level and hence employment of safeguards is not required
  - The practitioners are expected to **document** and to be able to **explain** the relevant facts and circumstances and the determination on the "threats and safeguards" evaluation



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## Extracted Quality Assurance Annual Report 2011

- "...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"



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## Extracted Quality Assurance Annual Report 2011

- "...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."



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## Provision of accounting and bookkeeping services to audit clients (cont'd)

### ***Audit clients who are public interest entities***

- The Code recognises that **more stringent requirements** are necessary in the event that an audit client is a public interest entity
- Under paragraph 290.172 of the Code, a firm **shall not provide accounting and bookkeeping services**, including payroll services, or prepare financial statements on which the firm will express an opinion or financial information which forms the basis of the financial statements for an audit client that is a public interest entity **except in emergency situations**



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## Provision of accounting and bookkeeping services to audit clients (cont'd)

- Despite paragraph 290.172 of the Code, a firm under paragraph 290.173 of the Code may provide accounting and bookkeeping services, including payroll services and the preparation of financial statements or other financial information, **of a routine or mechanical nature for divisions or related entities of an audit client that is a public interest entity** if the personnel providing the services are not members of the audit team and:
  - the divisions or related entities for which the service is provided are **collectively immaterial** to the financial statements on which the firm will express an opinion; or
  - the services relate to matters that are **collectively immaterial to the financial statements of the division or related entity**



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## Provision of accounting and bookkeeping services to audit clients (cont'd)

- The **emergency situation** as described refers to the situation where it is impractical for audit client to make other arrangements.
- This may be the case when:
  - (a) only the firm has the resources and necessary knowledge of the client's system and procedures to assist the client in the timely preparation of its accounting records and financial statements, and
  - (b) a restriction on the firm's ability to provide the services would result in significant difficulties for client (for example, as might result from a failure to meet regulatory reporting requirements). In such situations, the following conditions shall be met:



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## Provision of accounting and bookkeeping services to audit clients (cont'd)

- In such situations, the following conditions shall be met:
  - those who provide the services are not members of the audit team;
  - *the services are provided for only a short period of time and are not expected to recur; and*
  - *the situation is discussed with those charged with governance*
- Additional guidance is provided in the financial reporting and auditing alert issue 14 and 15 which can be accessed at <http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/financial-and-auditing-alert/>



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## Provision of accounting services to audit clients



**The firm audits the financial statements of a client who is not a public interest entity.**

**Is it permissible for the firm to provide services related to the preparation of accounting records and financial statements to that audit client in this situation?**



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## Provision of accounting services to audit clients (cont'd)

### Analysis:



- Identified threat
- Self review threat
- Threat evaluation
- The client must take the responsibility for accounting records preparation.
- The existence and significance of the threat depends on factors such as:  
(pls. see next slide)



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## Provision of accounting services to audit clients (cont'd)



...The existence and significance of the threat depends on factors such as:

- ❖ Whether the client is a public interest entity

- ❖ Whether the services are of routine or mechanical in nature
- ❖ Examples of such services include:
  - Providing payroll services based on client-originated data;
  - Recording transactions for which the client has determined or approved the appropriate account classification;
  - Posting transactions coded by the client to the general ledger;
  - Posting client-approved entries to the trial balance;
  - And preparing financial statements based on information in the trial balance



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## Provision of accounting services to audit clients (cont'd)



...The existence and significance of the threat depends on factors such as:

- ❖ Whether the management is familiar with accounting practices and/or principles
- ❖ In determining whether the services are of a routine or mechanical in nature, practitioners may consider the following non-exhaustive factors as part of its determination process:
  - the **complexity** of financial reporting requirements;
  - The **level of judgment** and/or subjectivity involved in the recognition, classification and measurement of the accounting transactions;
  - The total number of client's transactions and whether or not the transactions and/or balances are supported by third party documents, where the auditor are not required to re-compute figures or make any judgment or recognition, classification and measurement of each transaction.



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## Provision of accounting services to audit clients (cont'd)



Safeguard:

- Safeguard application
- If the audit client is a **public interest entity**, the auditor must decline or terminate the financial statements preparation service, except in emergency situation. (Paragraph 290.172)



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## Provision of accounting services to audit clients (cont'd)

### Safeguard:



- **Safeguard application**
- If the audit client is **not a public interest entity** and the **threat** is considered to be at an **acceptable level** based on evaluation, then no safeguard is need to be employed
- **Otherwise** and if the audit client is not a public interest entity, the firm is to apply safeguards to eliminate the threat or reduce it to acceptable level
- **Examples** of such safeguards include:  
(Pls. see next slide)



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## Provision of accounting services to audit clients (cont'd)

### Example of safeguards:



- ❖ Arranging for such services to be performed by an individual who is not a member of the audit team;
- ❖ If such services are performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the work performed;
- ❖ If the client has a limited number of transactions, ensure each transaction and balance of the client are supported by third party documents where the auditor does not re-compute figures or make any judgment on recognition, classification and measurement of each transaction.

- **If the threat cannot be reduced to an acceptable level by the application of safeguards, such non-assurance service shall not be provided**



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## Preparation of financial statements from client-prepared trial balance



The firm audits the financial statements where that **client prepares the accounting records and the trial balance** and accepts responsibility for preparing such information.

The **client's management is familiar** with the adjusting journal entries and **takes the responsibility** for the final financial statements.

Is it permissible for a firm to prepare their audit client's financial statements from the trial balance and propose adjusting journal entries in this situation?

❖ The auditor may undergo a similar analysis as highlighted in response to providing services related to the preparation of accounting records and financial statements to audit client who is not a public interest entity



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## Dialogue between the firm and audit client management



The audit process necessitates **dialogue between the firm and audit client management**, which may involve (i) application of accounting standards, policies and financial statement disclosure requirements; (ii) appropriateness of internal controls including financial and accounting controls and the methods used in determining the stated amounts of assets and liabilities; or (iii) proposing adjusting journal entries

Would these activities create threats to independence and hence the auditor is prohibited from performing these activities?

❖ The abovementioned activities are considered to be part of the audit process and do not generally, create threats to independence so long as audit client takes responsibility.



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## Technical assistance by the firms to audit clients



Occasionally the audit client may request **technical assistance** from the firm on matters such as (i) resolving account reconciliation problems or analyzing and accumulating information for regulatory reporting; (ii) providing technical advice on accounting issues such as the conversion of existing financial statements from one financial reporting framework to another (e.g. to comply with group accounting policies or to transition to a different financial reporting framework).

Would these activities create threats to independence and hence the auditor is prohibited from performing these activities?

❖ The abovementioned activities do not generally create threats to independence provided the firm does not assume a management responsibility for the client



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## Provision of taxation services for audit clients



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## Provision of taxation services for audit clients

- Taxation services comprise a broad range of services, including:
  - tax return preparation;
  - tax calculations for the purpose of preparing the accounting entries;
  - tax planning and other tax advisory services; and
  - assistance in the resolution of tax disputes



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## Tax return preparation

***For all audit clients, including public interest entities and non-public interest entities***

- Under paragraph 290.183 of the Code, tax return preparation services **involve assisting clients with their tax reporting obligations by drafting and completing information, including the amount of tax due (usually on standardized forms) required to be submitted to the applicable tax authorities**
  - Such services also include **advising on the tax return treatment of past transactions and responding on behalf of the audit client to the tax authorities' requests for additional information and analysis** (including providing explanations of and technical support for the approach being taken)



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## Tax return preparation

- Tax return preparation services are generally **based on historical information and principally involve analysis and presentation of such historical information under existing tax law, including precedents and established practice**. Further, the tax returns are subject to whatever review or approval process the tax authority deems appropriate
- Based on the above, providing tax return preparation services **does not generally create a threat to independence if management takes responsibility for the returns including any significant judgments made**.



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## Tax calculations for the purpose of preparing the accounting entries

### ***Audit clients that are not public interest entities***

- Under paragraph 290.184 of the Code, preparing calculations of current and deferred tax liabilities (or assets) for an audit client for the purpose of preparing accounting entries that will be subsequently audited by the firm creates a **self-review threat**



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## Tax calculations for the purpose of preparing the accounting entries

- The significant of the threat will depend on:
  - the complexity of the relevant tax law and regulation and the degree of judgment necessary in applying them;
  - the level of tax expertise of the client's personnel; and
  - the materiality of the amounts to the financial statements
- In relation to the complexity of the relevant tax law and regulation and the degree of judgment necessary in applying them, practitioners may consider whether the tax calculations are clearly supported by tax authority or other precedent, by established practice or has a basis in tax law that is likely to prevail



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## Tax calculations for the purpose of preparing the accounting entries

- If such services are to be provided to audit clients who are not public interest entities, safeguards shall be applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:
  - using professionals who are not members of the audit team to perform the service;
  - if the service is performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the tax calculations; or
  - obtaining advice on the service from an external tax professional



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## Tax calculations for the purpose of preparing the accounting entries

- It is possible to have circumstances that relevant threat is at an acceptable level and hence employment of safeguards is not required
  - The practitioners are expected to document and be able to explain the relevant facts and circumstances and the determination on the "threats and safeguards" evaluation



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### ***Audit clients that are public interest entities***

- Except in emergency situations, in the case of an audit client that is a public interest entity, a firm **shall not** prepare tax calculations of current and deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the financial statements on which the firm will express an opinion
- The emergency situations above refers to emergency or other unusual situations when it is **impractical** for audit client to make other arrangements. This maybe the case when:
  - (a) only the firm has the resources and necessary knowledge of the client's business to assist the client in the timely preparation of its calculations of current and deferred tax liabilities (or assets), **and**
  - (b) a restriction on the firm's ability to provide the services would result in significant difficulties for the client (for example, as might result from a failure to meet regulatory reporting requirements)



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- In such situations, the following conditions shall be met:
  - those who provide the services are not members of the audit team;
  - the services are provided only a short period of time and are not expected to recur; and
  - the situation is discussed with those charged with governance
- The practitioners who provide such service on the above emergency situation basis are expected to be able to document and explain the relevant facts and circumstances which warrant to be emergency situation



## Tax planning and other tax advisory services

***For all audit clients, including public interest entities and non-public interest entities***

- Tax planning or other tax advisory services comprise a broad range of services, such as advising the client how to structure its affairs in a tax effective manner or advising on the application of a new tax law or regulation
- **A self-review threat** may be created where the advice will affect matters to be reflected in the financial statements. The existence and significance of any threat will depend on factors such as:



## Tax planning and other tax advisory services

- the degree of **subjectivity** involved in determining the appropriate treatment for the tax advice in the financial statements;
- the extent to which the outcome of the tax advice will have a **material effect on the financial statements**;
- whether the **effectiveness of the tax advice depends on the accounting treatment** or presentation in the financial statements and there is **doubt as to the appropriateness of the accounting treatment** or presentation under the relevant financial reporting framework;
- the **level of tax expertise** of the client's employees;
- the extent to which the advice is **supported by tax law or regulation**, other precedent or established practice; and
- whether the tax treatment is **supported by a private ruling** or has otherwise been cleared by the tax authority before the preparation of the financial statements.



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## Tax planning and other tax advisory services

- Paragraph 290.188 of the Code states that providing tax planning and other tax advisory services **where the advice is clearly supported by tax authority or other precedent, by established practice or has a basis in tax law that is likely to prevail does not generally create a threat to independence**.
- If such services are to be provided to audit client, the significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.



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## Tax planning and other tax advisory services

- Examples of such safeguards include:
  - using professionals who are not members of the audit team to perform the service;
  - having a tax professional, who was not involved in providing the tax service, advise the audit team on the service and review the financial statement treatment;
  - obtaining advice on the service from an external tax professional; or
  - obtaining pre-clearance or advice from the tax authority



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## Tax planning and other tax advisory services

- It is possible to have circumstances that relevant threat is at an acceptable level and hence employment of safeguards is not required
  - The practitioners are expected to document and be able to explain the relevant facts and circumstances and the determination on the "threats and safeguards" evaluation



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## Tax planning and other tax advisory services

- Where the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements and:
  - the audit team has reasonable doubt as to the appropriateness of the related accounting treatment or presentation under the relevant financial reporting framework; and
  - the outcome or consequences of the tax advice will have a material effect on the financial statements on which the firm will express an opinion,
  - the **self-review threat would be so significant that no safeguards could reduce the threat to an acceptable level**. Accordingly, a firm shall not provide such tax advice to an audit client.



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## Assistance in the resolution of tax disputes

**For all audit clients, including public interest entities and non-public interest entities**

- Paragraph 290.192 of the Code states that an **advocacy or self-review threat** may be created when the firm represents an audit client in the resolution of a tax dispute once the tax authorities have notified the client that they have rejected the client's arguments on a particular issue and either the tax authority or the client is referring the matter for determination in a formal proceeding, for example before a tribunal or court.



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## Assistance in the resolution of tax disputes

- The existence and significance of any threat will depend on factors such as:
  - whether the firm has provided the advice which is the subject of the tax dispute;
  - the extent to which the outcome of the dispute will have a material effect on the financial statements on which the firm will express an opinion;
  - the extent to which the matter is supported by tax law or regulation, other precedent, or established practice;
  - whether the proceedings are conducted in public; and
  - the role management plays in the resolution of the dispute



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## Assistance in the resolution of tax disputes

- The significance of any threat created shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:
  - using professionals who are not members of the audit team to perform the service;
  - having a tax professional, who was not involved in providing the tax service, advise the audit team on the services and review the financial statement treatment; or
  - obtaining advice on the service from an external tax professional.



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## Assistance in the resolution of tax disputes

- It is possible to have circumstances that relevant threat is at an acceptable level and hence employment of safeguards is not required
  - The practitioners are expected to document and be able to explain the relevant facts and circumstances and the determination on the "threats and safeguards" evaluation
  - Paragraph 290.193 of the Code explains that where the taxation services involve acting **as an advocate** for an audit client before a public tribunal or court in the resolution of a tax matter and **the amounts involved are material to the financial statements on which the firm will express an opinion**, the advocacy threat created would be so significant that no safeguards could eliminate or reduce the threat to an acceptable level.
- Therefore, the firm shall not perform this type of service for an audit client



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## Assistance in the resolution of tax disputes

- Paragraph 290.193 of the Code explains that where the taxation services involve acting **as an advocate** for an audit client before a public tribunal or court in the resolution of a tax matter and **the amounts involved are material to the financial statements on which the firm will express an opinion**, the advocacy threat created would be so significant that no safeguards could eliminate or reduce the threat to an acceptable level.
- Therefore, the firm shall not perform this type of service for an audit client



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## Assistance in the resolution of tax disputes

- Paragraph 290.194 of the Code further clarifies that the firm is not, however, precluded from having a **continuing advisory role** (for example, responding to specific requests for information, providing factual accounts or testimony about the work performed or assisting the client in analyzing the tax issues) for the audit client in relation to the matter that is being heard before a public tribunal or court.



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## Preparation of financial information required to be submitted to the tax authorities as part of the client's tax reporting obligation



**The firm audits the financial statements of a client where that client is requesting the firm to compile financial information, including the amount of income tax due, required to be submitted to the tax authorities as part of the client's tax reporting obligation.**

**Can a firm compile such financial information for that audit client in this situation?**



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## Preparation of financial information required to be submitted to the tax authorities as part of the client's tax reporting obligation (cont'd)



### Analysis:

- |                     |   |
|---------------------|---|
| ▪ Identified threat | ▪ Not applicable  |
| ▪ Threat evaluation | <ul style="list-style-type: none"><li>▪ Compilation of such financial information is within the scope of tax return preparation services under paragraph 290.183 of the Code</li><li>▪ Tax return preparation services are generally based on historical information and principally involve analysis and presentation of such historical information under existing tax law, including precedents and established practice. The tax return information are subject to review or approval process the tax authority deems appropriate</li></ul> |



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## Preparation of financial information required to be submitted to the tax authorities as part of the client's tax reporting obligation (cont'd)



### Safeguard:

- |                         |   |
|-------------------------|---|
| ▪ Safeguard application | ▪ Such service does not generally create a threat to independence if management takes responsibility for the returns including any significant judgments made |
|-------------------------|---|



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## Respond on behalf of the audit client to the tax authority's requests for additional information and analyses



**The firm audits the financial statements of a client where the tax authority's request for additional information and analyses from that client**

**Can a firm advise an audit client on the tax return treatment of past transactions and respond on behalf of the client to the tax authority's requests for additional information and analyses (including providing explanations of, and technical support, for the approach being taken)?**



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## Respond on behalf of the audit client to the tax authority's requests for additional information and analyses (cont'd)



### Analysis:

- |   |  |
|---|--|
| <ul style="list-style-type: none"><li>▪ Identified threat</li><li>▪ Threat evaluation</li></ul> | <ul style="list-style-type: none"><li>▪ Not applicable</li><li>▪ Advising on tax return treatment of past transactions and responding on behalf of the audit client to the tax authorities' requests for additional information and analysis (including providing explanations of, and technical support, for the approach being taken) is within the scope of tax return preparation services under paragraphs 290.183 of the Code</li><li>▪ Such services are generally based on historical information and principally involve analysis and presentation of such historical information under existing tax law, including precedents and established practice</li></ul> |
|---|--|



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## Respond on behalf of the audit client to the tax authority's requests for additional information and analyses (cont'd)



### Safeguard:

- Safeguard application
- Such service does not generally create a threat to independence if management takes responsibility for the returns including any significant judgments made



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## Calculation of current and deferred taxation for accounting entries



**The firm audits the financial statements of a client where that client is requesting the firm to calculate its current and deferred tax liabilities (or assets) for the preparation of accounting entries that will be subsequently audited by the firm**

**Can the firm provide services on calculating current and deferred tax liabilities (or assets) to an audit client in this situation?**



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## Calculation of current and deferred taxation for accounting entries (cont'd)



### Analysis:

- Identified threat
- Self-review threat
- Threat evaluation
- The client must take the responsibility for the preparation of accounting entries
- The existence and significance of the threat depends on factors such as:
  - Whether the audit client is a public interest entity
  - Complexity of the relevant tax law and degree of judgment necessary in applying that
  - The level of tax expertise of the client's personnel
  - The materiality of the amounts involved to the financial statements



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## Calculation of current and deferred taxation for accounting entries (cont'd)



### Safeguard:

- Safeguard application
- If the audit client is a **public interest entity**, a firm shall **not perform such services** to the client except in emergency situation. (Paragraph 290.185)
- If the audit client is **not a public interest entity** and the **threat** is considered to be at an **acceptable level** based on evaluation, then **no safeguard is need to be employed**
- **Otherwise** and if the audit client is not a public interest entity, the firm is to **apply safeguards** to eliminate the threat or reduce it to an acceptable level
- **Example** of such safeguards include: (pls. see next slide)



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## Calculation of current and deferred taxation for accounting entries (cont'd)

### Example of safeguards:



- ❖ Using professionals who are not members of the audit team to perform the service
- ❖ If the service is performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the tax calculations
- ❖ Obtaining advice on the service from an external tax professional

- If the threat cannot be reduced to an acceptable level by the application of safeguards, such non-assurance service shall not be provided



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## Provision of tax planning and other advisory services to audit clients



The firm serves as the financial statements auditor of a client where the client is requesting the firm to provide tax planning and other tax advisory services which comprise a broad range of services such as advising the client how to structure its affairs in a tax efficient manner or advising on the application of a new law tax or regulation

Can a firm provide tax planning and other tax advisory services to an audit client in this situation?



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## Provision of tax planning and other advisory services to audit clients (cont'd)

### Analysis:



- Identified threat
- Threat evaluation
- Self-review threat may be created where the advice will affect matters to be reflected in the financial statements (Paragraph 290.187)
- The client must take the responsibility on consideration and implementation of the tax advice, and ultimately its tax treatment and reporting
- The existence and significance of the threat depends on factors such as:
  - the degree of subjectivity involved in determining the appropriate treatment for the tax advice in the financial statements
  - The extent to which the outcome of the tax advice will have a material effect on the financial statements



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## Provision of tax planning and other advisory services to audit clients (cont'd)

### Analysis:



- Threat evaluation (cont'd)
- Whether the effectiveness of the tax advice depends on the accounting treatment or presentation in the financial statements and there is doubt as to the appropriateness of the accounting treatment or presentation under the relevant financial reporting framework
- The level of tax expertise of the client's employees
- The extent to which the advice is supported by tax law or regulation, other precedent or established practice; and
- Whether the tax treatment is supported by a private ruling or has otherwise been cleared by the tax authority before the preparation of the financial statements



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## Provision of tax planning and other advisory services to audit clients (cont'd)

### Safeguard:



#### ▪ Safeguard application

- If the advice is clearly **supported by tax authority or other precedent, by established practice or has a basis in tax law that is likely to prevail**, providing such tax planning and other tax advisory services **does not generally create a threat to independence**. No safeguard is therefore needed in such circumstance



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## Provision of tax planning and other advisory services to audit clients (cont'd)

### Safeguard:



#### ▪ Safeguard application (cont'd)

- A firm shall not provide tax advice to an audit client if the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements and:
  - The audit team has reasonable doubt as to the appropriateness of the related accounting treatment or presentation under the relevant financial reporting framework; and
  - The outcome or consequence of the tax advice will have a material effect on the financial statements on which the firm will express an opinion



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## Provision of tax planning and other advisory services to audit clients (cont'd)

### Safeguard:



#### ▪ Safeguard application (cont'd)

- If the threat is considered to be at an acceptable level based on evaluation, then no safeguard is need to be employed
- Otherwise, the firm is to apply necessary safeguard to eliminate the threat or reduce it to an acceptable level
- Non-exhaustive examples of such safeguards include:

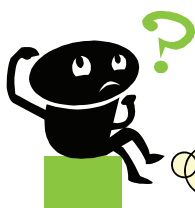


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## Provision of tax planning and other advisory services to audit clients (cont'd)



### Example of safeguards:

- ❖ Using professionals who are not members of the audit team to perform the service;
- ❖ Having a tax professional, who was not involved in providing the tax service, advise the audit team on the service and review the financial statement treatment
- ❖ Obtain advice on the service from an external tax professional
- ❖ Obtaining pre-clearance or advice from the tax authority

- If the threat cannot be reduced to an acceptable level by the application of safeguards, such non-assurance service shall not be provided



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## Representing an audit client in a formal proceeding on a tax dispute



The tax authorities have notified an audit client that they have rejected the client's arguments on a particular issue and either the tax authority or the client is referring the matter for determination in a formal proceeding, for example before a tribunal or court

Can a firm represent an audit client in the formal proceedings on a tax dispute in this situation?



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## Representing an audit client in a formal proceeding on a tax dispute (cont'd)



### Analysis:

- Identified threat
- Advocacy or self-review threat
- Threat evaluation
- The client must take the responsibility for its formal proceedings of the tax dispute
- The existence and significance of the threat depends on factors such as:
  - whether the firm has provided the advice which is the subject of the tax dispute
  - the extent to which the outcome of the dispute will have a material effect on the financial statements on which the firm will express an opinion
  - the extent to which the matter is supported by tax law, other precedent, or established practice
  - whether the proceedings are conducted in public
  - the role management plays in the resolution of the dispute



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## Representing an audit client in a formal proceeding on a tax dispute (cont'd)

### Safeguard:



- Safeguard application (cont'd)
- The firm shall not act as advocate for an audit client before a public tribunal or court in the resolution of a tax matter and when the amounts involved are material to the financial statements on which the firm will express an opinion (Paragraph 290.193)



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## Representing an audit client in a formal proceeding on a tax dispute (cont'd)

### Safeguard:



- Safeguard application (cont'd)
- If the threat is considered to be at an acceptable level based on evaluation, then no safeguard is need to be employed
- Otherwise, the firm is to apply necessary safeguard to eliminate the threat or reduce it to an acceptable level
- Non-exhaustive examples of such safeguards include:  
(Pls. see next slide)

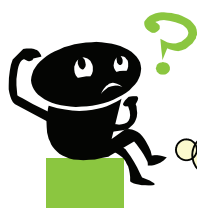


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## Representing an audit client in a formal proceeding on a tax dispute (cont'd)



### Example of safeguards:

- ❖ Using professionals who are not members of the audit team to perform the service;
- ❖ Having a tax professional, who was not involved in providing the tax service, advise the audit team on the service and review the financial statement treatment
- ❖ Obtain advice on the service from an external tax professional

- If the threat cannot be reduced to an acceptable level by the application of safeguards, such non-assurance service shall not be provided



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## Representing an audit client in a formal proceeding on a tax dispute (cont'd)



### Safeguard:

- Safeguard application (cont'd)
- Without representing an audit client in the resolution of a tax dispute, the firm is not precluded from having a continuing advisory role (for example, responding to specific requests for information, providing factual accounts or testimony about the work performed or assisting the client in analysing the tax issues) for the audit client in relation to the matter that is being heard before a public tribunal or court (Paragraph 290.194)
- In such circumstance, the client must take the responsibility for the information being provided to the authority



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## Part D

# Current Development



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## Responding to a Suspected Illegal Act

- In August 2012 IESBA issued an Exposure Draft on Responding to a Suspected Illegal Act, proposing new requirements of both professional accountants in public practice and in business, addressing their responsibilities in disclosing to an appropriate authority suspected illegal acts committed by clients or employers



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## Responding to a Suspected Illegal Act

- Under the proposal:
  - an accountant providing professional services to an **audit client**: required to disclose certain illegal acts to an appropriate authority;
  - an accountant providing **non-audit services** to a client that is not an audit client or a professional accountant in business: required to disclose the matter to the entity's external auditor and, in certain circumstances, the accountant would have a right to disclose certain illegal acts to an appropriate authority and would be expected to exercise that right.



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## Responding to a Suspected Illegal Act

- In December 2012 the Institute provided IESBA with a comment:
  - expressing substantial concern on whether the proposals will result in the imposition of fair and equitable requirements to professional accountants, especially in the absence of adequate statutory protection for whistle-blowers
  - The proposed requirement may also jeopardize the relationship between accountants and their clients or employers and promote mutual mistrust
  - The comment letter is available on the Institute's website



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## Responding to a Suspected Illegal Act

- IESBA received more than 70 comment letters on the Exposure Draft
  - The Institute's comments are generally consistent with the comments expressed by most of the other commentators
  - The IESBA will continue its consideration of key issues and future actions of this project at its forthcoming meeting



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## Review of Part C of IESBA Code - Requirements on professional accountants in business

- In February 2012, the IESBA established a Working Group to study reported accounting irregularities at certain companies and determined whether Part C of the Code should be strengthened to better promote ethical behavior by professional accountants in business
- In addition, IESBA considered that Part C had received less attention than other parts of the Code in recent years and therefore, the IESBA considered that a review of the Part C provisions would be timely



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## Review of Part C of IESBA Code - Requirements on professional accountants in business

- The IESBA approved a proposal at its March 2013 meeting to commence a project to review Part C of IESBA Code addressing professional accountants in business
  - Phase 1 of the project will review Sections 320 Preparation and Reporting of Information, 330 Acting with Sufficient Expertise and 340 Financial Interests of the Code
  - Phase 2 of the project will address Section 350 Inducements, which is related to facilitation payments and bribes.



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  - Phase 2 of the project will address Section 350 Inducements, which is related to facilitation payments and bribes.
- The IESBA will discuss this project further at forthcoming meetings.



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## Definition of Engagement Team

- In conjunction with the release of International Auditing and Assurance Standards Board International Standard on Auditing 610 (Revised 2013) *Using the Work of Internal Auditors*, the IESBA released in March 2013 amendments to the definitions of "engagement team" in the IESBA Code
- The amendments clarify the relationship between internal auditors providing direct assistance on an external audit and the meaning of an engagement team under the IESBA Code
- Such amendment will be effective for audits of financial statements for periods ending on or after 15 December 2014. Early adoption is permitted



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## Conflicts of Interest

- Recognizing the ethical questions and challenges that can arise from conflicts of interest, in March 2013 the IESBA issued an amendment to the IESBA Code to establish more specific requirements and provide more comprehensive guidance to support professional accountants in identifying, evaluating, and managing such conflicts.
- The revisions affect professional accountants both in public practice and in business, taking into account the different circumstances in which they work



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## Conflicts of Interest

- The amendment is aimed to provide a clarified explanation of what a conflict of interest means under the IESBA Code
  - The changes also are aimed at better enabling professional accountants to identify potential conflicts of interest early for timely action to be taken by the affected parties
  - Moreover, the new requirements are intended to encourage professional accountants to evaluate whether they can remain objective in those circumstances and abide by the other fundamental ethical principles in the IESBA Code
- The amendment will be effective on 1 July 2014 where early adoption is permitted



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## Breach of a Requirement of the Code

- Reflecting its view that any breach of a provision of the IESBA Code is a matter that must be handled seriously, the IESBA has strengthened the Code with respect to a professional accountant's actions when encountering such a breach
- In particular, the revisions to the IESBA Code establish a robust framework for addressing a breach of an independence requirement.



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## Breach of a Requirement of the Code

- They include requiring a firm to:
  - Terminate, suspend, or eliminate the interest or relationship that caused the breach;
  - Evaluate the significance of the breach and determine whether action can be taken and is appropriate in the circumstances to satisfactorily address the consequences of the breach;
  - Communicate all breaches with those charged with governance and obtain their concurrence that action can be, or has been, taken to satisfactorily address the consequences of the breach; and
  - Document, among other matters, the action taken and all the matters discussed with those charged with governance
- The amendment will be effective on 1 April 2014 and early adoption is permitted



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# Thank you for your attention



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## **A Refresher Course on Current Auditing Standards**

### **Day 5**

<b>Time</b>		<b>Topic</b>
9:00	- 10:45	Fundamental principle of professional ethics
10:45	- 11:00	Break
11:00	- 12:00	Examination