

# Alert

Updates on financial reporting and auditing



Issue 8 (March 2010)

Dear members,

## **Report on practice reviews of practices with listed clients**

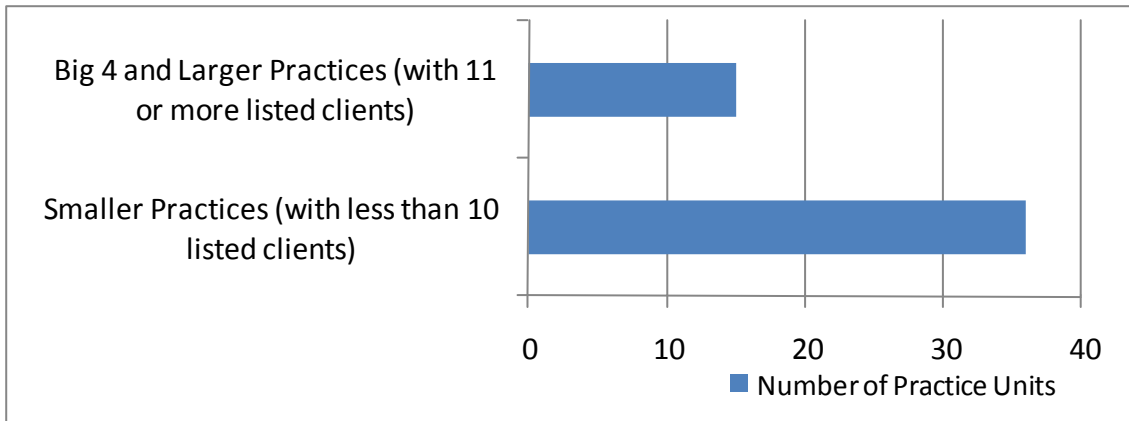
The practice review programme gives priority to reviews of practices that have listed clients in view of the public interest involved. The practice review committee is committed to reviewing all practices with listed clients at least every three years. Additionally the committee has decided that due to the size and significant public interest element of their client base, the Big Four practices will be reviewed annually.

From the second half of 2007, the quality assurance department of the Institute started carrying out reviews of practices with listed clients within a three year period. By the end of 2009, the department had completed the first review cycle of all practices with listed clients, which is more than six months ahead of the time committed by the practice review committee.

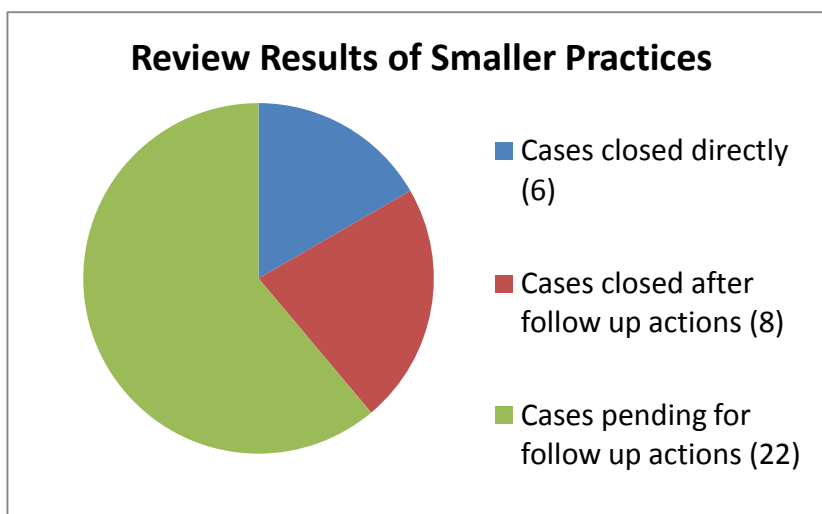
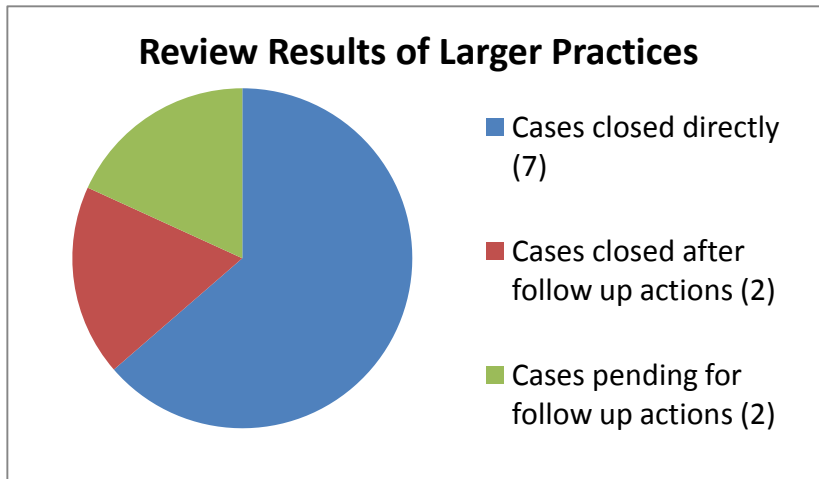
The scope of each review included understanding the practice's quality control system, assessing its effectiveness in complying with HKSQC 1, and assessing compliance with professional standards in the operation of quality control policies and procedures and the conduct of audit work. Where we identified issues, the practices were asked to prepare remedial action plans and the effectiveness of these plans was confirmed by follow-up reports submitted by the practices or from additional visits.

### **Reviews statistics and results**

In the first review cycle, the quality assurance department reviewed 51 practices with listed clients. The Big Four practices were subject to three annual reviews. Seven practices received a follow-up review and four follow-up reviews are scheduled in 2010. We may do more follow-up reviews after receiving and analyzing status reports from practices reviewed in 2009. A total of 67 listed entity audit engagements were reviewed by the department during this cycle.



Approximately 90 percent of Hong Kong listed entities are audited by 15 practices (Big Four and 11 other larger practices that have 11 or more Hong Kong listed clients). A total of 36 smaller practices (those with less than 10 Hong Kong listed clients) audited the remaining 10 percent of listed entities. Most of these smaller practices have one or two listed clients.



Reviews for Big Four practices were all directly closed, reflecting the outcome of the department's reviews and the strength of procedures that these practices are able to develop and implement. For larger practices, most cases were closed directly and only four cases required follow-up actions.

In general, the department is satisfied that Big Four and larger practices have the commitment and resources to implement effective quality control and to address all matters raised by the practice review teams.

Out of the 36 reviews of the smaller practices, only six cases were closed directly while most of the cases required follow-up actions. These actions included asking the practices to prepare remedial action plans and follow-up reports or follow-up visits. As a general observation, the department considers that smaller practices need to devote more effort and resources to the effectiveness of their quality control and compliance with professional standards, and to address the particular challenges of listed company audits.

Up to the date of this report, no case has been pursued for disciplinary action.

### **Review findings**

The following is a summary of findings from reviews of practices with listed clients. The matters noted were particularly evident in reviews of smaller practices. Many of the matters relating to engagement performance were also found in reviews of practices with no listed company clients.

Most of the practices have documented quality control policies and procedures in quality control manuals but there were cases that not all policies and procedures were implemented. For some practices, monitoring required under HKSQC 1 had not been fully implemented at the time of review. All practices with listed clients have implemented or were committed to implement the monitoring function properly after the reviews took place.

#### *Client acceptance and continuance*

Practices need to establish policies and procedures for the acceptance and continuance of listed client relationships. Practices should consider whether they have the capabilities, time and resources to perform audits of listed clients. In particular, the practices should assess whether they have appropriate levels of experience and competence to understand and handle complex business transactions and accounting issues which commonly exist in listed entities. There were instances where practices were unable to understand the transactions and identify the audit risks. This led to some cases where there was a lack of clarity over the identification of significant risks, insufficient consideration of fraud risks and a failure to evaluate the design and implementation of controls over significant risks.

Practices were reminded to exercise extra caution when accepting a client where there has been a qualified audit opinion or a regular change of auditor, as such circumstances could be indicative of potential engagement risks.

In recognition of the public interest sensitivity and potential high risk attached to listed clients, professional standards require rotation of engagement partners after a period of, normally no more than seven years, and the appointment of a suitably qualified and experienced person to carry out an engagement quality control review. Practices with listed clients should consider whether they have sufficient resources to implement a partner rotation policy and have personnel with sufficient technical expertise and experience to carry out an effective engagement quality control review.

#### *Independence*

For smaller practices, audit fees from listed clients may form a significant portion of their total revenue. Fee pressure and the importance of the client relationship may impair the practice's independence in appearance. The practice should identify, evaluate and address any potential threats to independence and apply appropriate safeguards to mitigate them. If no appropriate safeguards can be put in place, the practice should consider not accepting or resigning from the engagement.

#### *Valuation of assets*

There were instances where the work undertaken in respect of verification of valuation of assets, assessment of impairment of assets, and/or fair value of assets and liabilities was insufficient. Some practices relied on management's representations without documenting an assessment of the reasonableness of the directors' valuation. In other cases where a valuation report was prepared by an external valuer, which was common for listed entities, the objectivity of the valuer, the adequacy and appropriateness of the valuer's work were not sufficiently assessed by the practice.

#### *Subcontracting audit works*

The quality assurance department reviewers have identified that some practices subcontracted elements of the audit work to other practices or individuals either in or outside Hong Kong. The practices were reminded that they retained full responsibility for all aspects of the audit and must ensure control and management of the audit process. It is inappropriate to rely on the subcontractors' work without understanding and assessing the audit methodology adopted and assessing the sufficiency and reliability of the audit evidence obtained.

Some practices had placed reliance on other auditors work. The practices were reminded that they should consider whether their own participation is sufficient to be able to act as the principal auditors and determine how the work of the other auditors will affect the audit. The principal auditors should perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditors is adequate for the principal auditors' purposes. There were cases where the principal auditors obtained reports issued by other auditors through the clients without communicating with the other auditors or reviewing the other auditors' work papers to assess whether there were any significant findings in subsidiary audits that may have an impact on the group opinion.

### *Going concern*

The consideration of going concern assumption is always an important audit area. It was noted in a number of cases that the quality and extent of evidence on file to support the assessment of the appropriateness of going concern assumption required improvement.

### *Communications*

Practices should communicate matters of governance interest arising from the audit with those charged with governance of an entity, for example, audit committee. Some practices omitted to document the matters of governance interest communicated and any responses to those matters. When such matters are communicated orally, it is important to document what has been said.

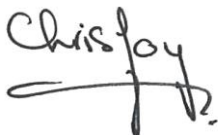
The results of reviews suggest that audits of listed entities demand a much higher level of resources and technical knowledge than some of the smaller practices estimated.

### **The future**

Through the first cycle of review, the quality assurance department and the practice review committee have sought to give practices reasonable time and encouragement to address weaknesses in policies, procedures and audit approach. A new three-year review cycle for practices with Hong Kong listed clients has commenced in 2010. The department will ensure that all practices taking up listed clients will be covered as a priority in this review cycle. Given the fact that HKSQC 1 has been effective since 2005 and that most practices will have been reviewed at least once in the first review cycle, the department will be basing its evaluations on the expectation that improved levels of compliance with professional standards will be found in the new round of reviews. Where the findings are "repeats" of matters raised in a previous review, these are likely to result in more stringent follow-up actions.

If the department and the committee are not satisfied with that appropriate action has been taken to rectify deficiencies identified in previous reviews, the committee will consider whether to exercise its right to raise complaints to the council of the Institute for disciplinary actions in order to ensure that the practice review programme continues to operate robustly and effectively.

Our policies, procedures and documentation will be refined in light of experience gained in conducting reviews. The Institute is fully committed to providing technical advisory and training services for members. The knowledge obtained during the reviews will be used to develop training programmes and other support activities and the department will work closely with the Institute's technical and support unit to provide appropriate technical forums to members.



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