

# Alert

Updates on financial reporting and auditing



Issue 14 (18 February 2011)

Dear members,

## **Preparation of accounting records and financial statements for an audit client**

### **Recent court judgment on a disciplinary action by the Institute**

On 29th June 2009, at a Disciplinary Committee hearing, a practising member was found to have breached section 34(1)(a)(vi) of the Professional Accountants Ordinance in that the member failed or neglected to observe, maintain or otherwise apply paragraph 2 of Statement 1.203 *Professional Ethics – Integrity, Objectivity and Independence* in the audit of the financial statements of a private company for the year ended 31 December 2003. The member's breach of Statement 1.203 arose in the circumstance where audit work was carried out by his part-time employee who also prepared the financial statements being audited and was the company secretary of the client company.

Paragraph 2 of Statement 1.203 states that "A member in public practice should be, and be seen to be, free in each professional assignment he undertakes of any interest which might detract from objectivity. The fact that this is self-evident in the exercise of the reporting function must not obscure its relevance in respect of other professional work. "

The practising member appealed against the decision of the Disciplinary Committee to the Court of Appeal. The court heard the case and in its judgment handed down on 30 November 2010 affirmed the decision of the Disciplinary Committee.

Please refer to the [extract of the reasons and order](#) by the Disciplinary Committee and the [court judgment](#) should you wish to see further details on the case.

Following the decisions of the Disciplinary Committee and the Court of Appeal, we have become aware that there are concerns among some members over the acceptability of a practice providing non-audit services, in particular accounting service, to its audit clients. This situation is not uncommon among many SMP members auditing private companies in Hong Kong.

***The court's judgment was based on case-specific facts and circumstances. The court held that whether or not objectivity may be threatened or appear to be threatened is fact-sensitive, and while participation in the preparation of accounting records may be acceptable, that would depend on the nature of the participation. However, the court found that it could not possibly cover a situation in this case where the person conducting the audit had himself prepared the financial statements that were the subject matter of the audit, as the perceived conflict of interest was all too obvious to require any elaboration.***

### **The requirements under the Institute's Code of Ethics for Professional Accountants**

Statement 1.203, which was relevant for the above-mentioned case, has since been replaced by the Institute's Code of Ethics for Professional Accountants. The Code was issued in December 2005, effective from 30 June 2006, and was further revised in June 2010, effective from 1 January 2011. Click [here](#) for the revised Code.

The Code is based on the principle of "threats and safeguards". Auditors are required to assess potential threats to independence and, where possible, implement safeguards to eliminate or reduce the threat to an acceptable level.

**Members are assured that the revised Code and the law does continue to allow members to provide accounting services, to their audit clients upon certain conditions being satisfied. To help members, we set out below the latest requirements and guidance in the revised Code.**

The requirements governing "Preparing Accounting Records and Financial Statements" in the revised Code are set out in paragraphs 290.167 to 290.174.

Paragraph 290.167 of the revised Code confirms that management is responsible for preparation and fair presentation of financial statements in accordance with the applicable financial reporting framework.

Paragraph 290.168 of revised 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.

A client may request technical assistance from its auditor on matters such as resolving account reconciliation problems or analyzing and accumulating information for regulatory reporting. In addition, a client may request technical advice on accounting issues such as the conversion of existing financial statements from one financial reporting framework to another (for example, to comply with group accounting policies or to transition to a different financial reporting framework such as Hong Kong Financial Reporting Standards). Such services do not, generally, create threats to independence provided the auditor does not assume management responsibility [290.170]. The key to maintaining the correct independent position is to ensure that the audit firm does not assume management responsibility for an audit client [290.165].

### **Audit clients that are not public interest entities**

Under paragraph 290.171 of revised Code, a firm may provide services by way of 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;
- Posting client-approved entries to the trial balance; and
- Preparing financial statements based on information in the trial balance.

In all cases, the significance of any threat created shall be evaluated and, if necessary, appropriate safeguards applied 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.

**Members are reminded that when providing services in relation to preparation of accounting records and financial statements to audit clients that are not public interest entities, it is necessary to evaluate the significance of any threat created and employ appropriate safeguards.**

There are no exemptions from the requirements of the revised Code for small audit firms but in monitoring compliance with the revised Code a pragmatic approach will be taken as far as possible.

### **Audit clients that are public interest entities**

The revised Code recognizes that more stringent requirements are necessary in the event that an audit client is a public interest entity. Under paragraph 290.172 of revised Code, except in emergency situations 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.

A firm 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 services are 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.

In emergency situations or other unusual situations and when it is impractical for the audit client to make other arrangements, paragraph 290.174 states that accounting and bookkeeping services, which would otherwise not be permitted under this section, may be provided to audit clients in emergency. This may be the case when

- Only the firm has the resources and necessary knowledge of the client's systems and procedures to assist the client in the timely preparation of its accounting records and financial statements, and
- 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 requirements). 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.

### **Serving as a director or officer of an audit client**

The above case has the additional complication of the individual who carried out audit work and prepared financial statements also being the company secretary of the audit client. This is an extreme situation which would not be often encountered.

Members are reminded of the requirements in the revised Code in relation to serving as a director or officer of an audit client which are set out in paragraphs 290.146 to 290.149:

290.146 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 a director or officer of an audit client.

290.147 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 of the entity.

290.148 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. (In this context "permitted" means not explicitly barred.)



290.149 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.

The above summary illustrates that the result of the disciplinary findings and the judgment of the Court of Appeal does not represent a change in policy regarding the provision of accounting services and company secretarial services by auditors. It was a fact specific result that will not necessarily apply to all cases of auditors providing accounting services to audit clients. The key points are that in such circumstances auditors should go through the "threats and safeguards" process, ensure that they do not assume any management responsibility and recognize that partners and staff cannot act as officers of the audit client.

Should members have further enquiries with the above guidance, please send us an email via the Institute's [Technical Enquiry system](#) .

Thank you for your kind attention.

Sincere regards,

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Hong Kong Institute of Certified Public Accountants

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