

Disclaimer

- ◆ **The materials of this seminar are intended to provide general information and guidance on the subject concerned. Examples and other materials in this seminar are only for illustrative purposes and should not be relied upon for technical answers. The Hong Kong Institute of Certified Public Accountants (The Institute), the speaker(s) and the firm(s) that the speaker(s) is representing take no responsibility for any errors or omissions in, or for the loss incurred by individuals or companies due to the use of, the materials of this seminar conference.**
- ◆ **No claims, action or legal proceedings in connection with this seminar brought by any individuals or companies having reference to the materials on this seminar will be entertained by the Institute, the speaker(s) and the firm(s) that the speaker(s) is representing.**



Module C – Business Assurance



Module Preparation Seminar – Agenda

- **Evaluation of misstatements (HKSA 450)**
- **Going concern (HKSA 570)**
- **Audit reporting**
 - **HKSA 700 (Revised) Forming an opinion and reporting on financial statements**
 - **HKSA 701 Communicating key audit matters in the independent auditor's report**
 - **HKSA 705 (Revised) Modifications to the opinion in the independent auditor's report**
 - **HKSA 706 (Revised) Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report**
 - **HKSA 720 (Revised) The auditor's responsibilities relating to other information**



Evaluation of misstatements (HKSA 450)

MC – Evaluation of misstatements (HKSA 450)



Definition

Misstatement is a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework.

Misstatements can arise from error or fraud.

Uncorrected misstatements are misstatements that the auditor has accumulated during the audit and that have not been corrected.

HKSA 450 *Evaluation of Misstatements Identified during the Audit* deals with the auditor's **responsibility** to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

The **objectives** of the auditor are to evaluate:

- (a) The effect of identified misstatements on the audit; and
- (b) The effect of uncorrected misstatements, if any, on the financial statements.

MC – Evaluation of misstatements (HKSA 450)



HKSA 450 requires that the auditor **shall accumulate misstatements identified** during the audit other than those that are clearly trivial.

'**Clearly trivial**' is not another expression for 'not material'; clearly inconsequential.

HKSA 450 requires the auditor to accumulate misstatements other than those which are clearly trivial identified during the audit. It is necessary to distinguish misstatements as follows : **Factual misstatements/ Judgment misstatements / Projected misstatements**

Misstatements in disclosures may also be clearly trivial whether taken individually or in aggregate, and whether judged by any criteria of size, nature or circumstances.

MC – Evaluation of misstatements (HKSA 450)



Consideration of identified misstatements as the audit Progresses

The auditor shall determine whether the **overall audit strategy and audit plan** need to be revised if there are identified misstatements or the other misstatements in aggregate are material. The auditor shall perform additional audit procedures to determine whether misstatements remain, the amount of the actual misstatement and whether adjustments shall be made.

The **cumulative effect of immaterial uncorrected misstatements** related to prior periods may have a material effect on the current period's financial statements. Auditors are advised to use the same evaluation approach for consistency.

MC – Evaluation of misstatements (HKSA 450)



Evaluating the effect of uncorrected misstatements the auditor shall consider:

- The **size and nature of the misstatements**, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
- The **effect of uncorrected misstatements** related to prior periods on the relevant classes of transactions, accounts balances or disclosures, and the financial statements as a whole.

MC – Evaluation of misstatements (HKSA 450)



Qualitative Disclosure

In addition, each individual misstatement of a qualitative disclosure is considered to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole.

Examples where such misstatements may be material include:

- Inaccurate or incomplete descriptions of information about the objectives, policies and processes
- The omission of information about the events or circumstances that have led to an impairment loss
- The incorrect description of an accounting policy
- The inadequate description of the sensitivity of an exchange rate in an entity

MC – Evaluation of misstatements (HKSA 450)



Communication and correction of misstatements

The auditor shall communicate on a **timely basis** all misstatements accumulated during the audit with the **appropriate level of management**, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements. The auditor's communication shall identify material uncorrected misstatements individually.

Refusal to correct misstatements

The auditor shall request management to correct those misstatements accumulated during the audit. If management **refuses** to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of **management's reasons** for not making the corrections and shall take that understanding into account when evaluating whether the **financial statements as a whole** are free from material misstatement.

MC – Evaluation of misstatements (HKSA 450)



Obtain written representations and documentation

The auditor shall request a **written representation from management** and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

The auditor shall include in the audit documentation:

- The amount below which misstatements would be regarded as clearly unimportant
- All misstatements accumulated during the audit and whether they have been corrected
- The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion

Past Paper practice

HKICPA MC - Jun 2016 Qu 7



You are the audit engagement manager of Star Limited. You understand that the financial statements of Star Limited will be used for financial due diligence performed by a potential investor of Star Limited. The materiality of this engagement was set at HK\$50,000. During your review of the audit working papers of Star Limited for the year ended 31 December 2015, you noted the following unadjusted errors identified by the audit engagement team.

Past Paper practice

HKICPA MC - Jun 2016 Qu 7 (Cont'd)



Errors with profit or loss impact:

No.	Description	Increase/ (decrease) in profit HK\$
1	Overstatement of accrued salaries for current year	5,000
2	Overstatement of sales due to cut-off error	(135,000)
3	Overstatement of cost of sales due to cut-off error as referred to No. 2 above	75,000
	Total pre-tax impact	<hr/> (55,000)
	Tax at 16.5%	9,075
	After-tax impact	<hr/> (45,925) <hr/>

Errors with no profit or loss impact:

No.	Description	Amount HK\$
4	Trade receivables wrongly classified as trade payables	500,000
5	Omission of disclosure of a capital commitment in the notes to financial statements	300,000

Past Paper practice



HKICPA MC - Jun 2016 Qu 7 (Cont'd)

The statements of financial position of Star Limited as at 31 December 2015 and 2014 before any adjustment of the above errors are set out below:

	2015 HK\$	2014 HK\$
Trade receivables	1,000,000	800,000
Cash and bank balances	200,000	250,000
Total current assets	1,200,000	1,050,000
Trade payables	700,000	800,000
Accrued expenses	50,000	50,000
Total current liabilities	750,000	850,000
Net assets	450,000	200,000
Equity	450,000	200,000

Past Paper practice



HKICPA MC - Jun 2016 Qu 7 (Cont'd)

Required:

(a) Based on the materiality of this engagement which was set at HK\$50,000, evaluate whether each of the unrecorded misstatements (Nos. 1 to 5) is material to the financial statements of Star Limited.

(12 marks)

(b) Describe your responsibilities relating to the communication of these unrecorded misstatements to the management and to those charged with governance.

(4 marks)

Past Paper practice

HKICPA MC - Jun 2016 Qu 7



Answer (a)

HKSA 450 (Clarified) *Evaluation of Misstatements Identified during the Audit* deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

The auditor shall determine whether these uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

- (a) the size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and
- (b) the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

The identified misstatements for Nos. 1 to 5 are regarded as factual misstatements - misstatements without doubt.

Past Paper practice

HKICPA MC - Jun 2016 Qu 7



Answer (a) (Cont'd)

No. 1 represents overstatement of accrued expenses. As the impact is less than the materiality, this individual uncorrected misstatement is considered as not material.

Nos. 2 and 3 represent the cut-off errors on sales and cost of sales which should be considered together. The net impact of these two items resulted in overstatement of profit before tax of HK\$60,000 and net profit of HK\$50,100 which exceeds/ approaches materiality, accordingly, these uncorrected misstatements are considered material.

Since the sales cut-off error (Nos. 2 and 3) is considered to be material, it is unlikely that it can be offset by other misstatements (i.e. No.1). Therefore, the auditor should not offset No. 1 with Nos. 2 and 3 when evaluating the cumulative impact of the identified misstatements.

Past Paper practice

HKICPA MC - Jun 2016 Qu 7



Answer (a) (Cont'd)

No. 4 is related to the misstatement in classification. Although no profit or loss impact arose, the auditor shall evaluate other factors when determining whether a classification misstatement is material. As referred to in the statement of financial position of Star Limited as at 31 December 2015, the uncorrected reclassification misstatement would distort the current assets and current liabilities, this uncorrected misstatement is considered as material.

No. 5 is related to the misstatement regarding disclosure. The auditor shall evaluate qualitative factors when determining whether such an omission is material. As the financial statements of Star Limited will be used by a potential investor for his investment decision, capital commitment is regarded as key financial information by the potential investor, the misstatement of omitting this financial disclosure is material.

The auditor would also need to evaluate the aggregate impact of these uncorrected misstatements. Considering the fact that the use of these financial statements is for a potential investor to make his investment decision, the uncorrected misstatements which would present a more favorable financial position (such as higher profit, less liability level, and lack of capital commitment) are considered as material misstatements to the financial statements as a whole.

Past Paper practice



HKICPA MC – Dec 2017 – Qu 8b

Company D is a sportswear trading company in Hong Kong. You are the auditor of Company D. The overall materiality and the de minus level of misstatements are HK\$800,000 and HK\$40,000 respectively. The de minus level of misstatements sets the threshold for clearly trivial misstatements.

The annual audit is substantially completed. During the course of the audit, the following audit findings are identified.

- (i) A sales cut-off error that amounted to HK\$5 million, is identified in one of the sales cut-off test samples. This represented only an insignificant amount of the total revenue of Company D, with a profit margin ratio of 10%. It is currently uncertain whether the sales cut-off error is an exceptional one.
- (ii) Certain aged inventories that amounted to HK\$500,000 are identified through the review of the inventory ageing report. The sales reports indicated that there were no sales of these inventory items in the past year. The management of Company D currently considers that no inventory provision is necessary.

Past Paper practice



HKICPA MC – Dec 2017 – Qu 8b (Cont'd)

Required:

- (b) Assume the facts presented above are all misstatements found in the audit, evaluate and explain whether these misstatements may result in misstatement(s) recorded in the summary of uncorrected misstatements represented by the management of Company D or audit adjustment(s) to be adjusted in the financial statements.

(4 marks)

Past Paper practice

HKICPA MC – Dec 2017 – Qu 8b



Answer

When the misstatements are assessed individually,

(i) Sales cut-off error

When assessing the impact of the sales cut-off error on the financial statements, the related reversal of cost of goods sold in the financial statements should also be considered. The net impact on the financial statements as a result of the sales cut-off error amounted to HK\$500,000 (i.e. HK\$5 million x 10%), represented the profit margin of the sales transaction. As the net financial impact on the financial statements is below the overall materiality (i.e. HK\$800,000) but exceeds the de minus level of misstatement (i.e. HK\$40,000), the misstatement should be included in the summary of uncorrected misstatement for overall assessment.

Past Paper practice

HKICPA MC – Dec 2017 – Qu 8b



Answer (Cont'd)

(ii) Inventory provision

The provision for inventory amounted to HK\$500,000, which is below the overall materiality (i.e. HK\$800,000) but exceeds the de minus level of misstatement (i.e. HK\$40,000), the misstatement should be included in the summary of uncorrected misstatement for overall assessment.

However, HKSA 450 *Evaluation of Misstatements Identified during the Audit* requires that the audit shall accumulate misstatements identified during the audit other than those that are clearly trivial.

When the misstatements are assessed in aggregate, since the aggregated misstatements (i.e. HK\$1,000,000) summarised in the summary of uncorrected misstatements now exceed the overall materiality (i.e. HK\$800,000), the auditor should discuss with management to correct the misstatements identified in the financial statements.



Going concern (HKSA 570)

MC – Going Concern



Auditors should consider whether **the going concern basis of accounting is appropriate**, and whether disclosure of any going concern problems is sufficient.

HKSA 570 (Revised) *Going Concern* provides guidance to auditors in this area. The objectives of the auditor are :

- To obtain **sufficient appropriate audit evidence** regarding, and to conclude on, the **appropriateness of management's use of the going concern basis** of accounting in the preparation of the financial statements;
- To conclude, based on the audit evidence obtained, **whether a material uncertainty exists related to events or conditions** that may cast significant doubt on the entity's ability to continue as a going concern

MC – Going Concern



Under the going concern basis of accounting, the financial statements are prepared on the assumption that the **entity is a going concern and will continue its operations for the foreseeable future.**

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

MC – Going Concern



Going concern indicators

HKSA 570 (Revised) includes examples of events or conditions that may cast doubt about the going concern assumption (going concern indicators).

Examples :

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

MC – Going Concern



Going concern indicators

Examples :

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
- Labour difficulties
- Shortages of important supplies
- Emergence of a highly successful competitor

MC – Going Concern

Management's responsibilities



It is **management's responsibility** to make assessment on whether the entity can continue as a going concern, not the auditor's responsibility.

When management is **aware of material uncertainties** that may cast significant doubt upon the entity's ability to continue as a going concern, **uncertainties should be disclosed**.

Management's assessment must cover **a period of not less than 12 months from the date of the financial statements**. If it is less than 12 months, the auditor should ask management **to extend its assessment**. The auditor shall cover the same period as performed by the management, or by law or regulation if it specifies a longer period.

The auditor does not have **to carry out specific procedures** to identify problems which may occur after the period covered by management's assessment.

MC – Going Concern



Procedures for events or conditions identified:

- **Requesting management** to make its assessment of the entity's ability to continue as a going concern where this has not been done'
- Evaluating management's plans for **future actions** in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.
- Evaluating the reliability of the underlying data generated to prepare the forecast and determining whether there is adequate support for the assumptions underlying the forecast.
- Performing audit procedures regarding subsequent events
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties

MC – Going Concern



Procedures for events or conditions identified:

- Considering whether any additional facts or information have become available since the date on which management made its assessment'
- **Inquiring** of the entity's legal counsel regarding **litigation and claims**
- **Analysing and discussing cash flow**, profit and other relevant forecasts with management
- Reviewing terms of debenture or bank loans
- Requesting **written representations** from management and those charged with governance about plans for future action and the feasibility of these plans
- Confirming the existence, terms and adequacy of **borrowing facilities**

MC – Going Concern

Audit reporting



Use of going concern appropriate but a material uncertainty exists

The auditor determines whether disclosures in the financial statements are adequate. Specifically, whether the financial statements adequately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and management's plans to deal with these events or conditions.

Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended 31 December 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

MC – Going Concern



Disclosure not adequate when a material uncertainty exists

If disclosures are not adequate, then the opinion will be either **a qualified or an adverse opinion**:

If adequate disclosure is not made in the financial statements, the auditor shall:

- Express a qualified opinion or adverse opinion, as appropriate, in accordance with HKSA 705 (Revised); and
- In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

Past Paper practice

HKICPA MC - Dec 2015 Qu8b



Solar Energizer Limited (“Solar”) is a company incorporated in the Cayman Islands and listed in Hong Kong. Its principal activities are the manufacturing and trading of devices which convert solar energy directly into electricity using special cells and modules. It also participates in large scale construction projects providing solutions to companies switching to solar energy. Many share market analysts have placed very high expectations on Solar’s upcoming result announcement. Solar’s recent share price has increased 10 times compared to a year ago.

Alan is the audit engagement partner of Solar. Two days before Solar’s current year results announcement, the management told Alan that they had just identified a product defect in one of their major products and planned to announce a large scale product recall immediately after the results announcement. The audit engagement team has substantially completed the 31 December 2014 year-end audit. The only outstanding piece of work was the review of the product recall and its financial and disclosure impact on the financial statements.

After learning from the management about Solar’s product recall, Alan explained to the management that he needs more information to understand the financial impact of the product recall.

Past Paper practice

HKICPA MC - Dec 2015 Qu8b



Solar's management estimated that additional costs of HK\$10 million would be incurred in response to the product recall programme but refused to recognise such a provision in the financial statements for the year ended 31 December 2014. The pre-tax profit of Solar for the year ended 31 December 2014 before the adjustment of the provision is approximately HK\$100 million.

On the same night, Alan attended a reunion event with his university classmates. One of his classmates, Michael, asked for Alan's view of Solar's business performance. Michael plans to invest HK\$5 million in Solar as he strongly believes in Solar's business model and the management team.

Required

The product recall has been identified as a significant subsequent event after the end of the reporting period by the audit engagement team. What are the audit responsibilities of the audit engagement team in assessing the impact of the product recall on the financial statements? What would be the possible material misstatements on the financial statements in view of the product recall?

(7 marks)

Past Paper practice

HKICPA MC - Dec 2015 Qu8b



Answer

HKSA 560 (Clarified) *Subsequent Events* provides guidance on the additional procedures the auditor should perform if he is aware of a subsequent event which materially affects the financial statements.

The audit procedures to identify subsequent events should be timed to occur as near as practicable to the date of the auditor's report. The auditor has the responsibility to perform audit procedures to obtain sufficient appropriate audit evidence for any subsequent events up to the date of the auditor's report if they may require adjustment of, or disclosure in, the financial statements.

Given the fact that the product recall is now known to Alan, Alan and his audit engagement team have the responsibility to assess the possible accounting and auditing impact in response to the product recall.

Past Paper practice

HKICPA MC - Dec 2015 Qu8b



Answer (Cont'd)

The large scale product recall is likely to have a significant impact on the financial statements of Solar. The inventory balance of Solar at year end may be materially overstated as the affected products may not have any sales value. The warranty provision balance of Solar at year end may also be understated as additional costs may have to be incurred for fixing the recalled products or replacing the recalled products for the customers. Additional disclosures should also be considered on contingent liabilities if any litigation and claims arise as a result of the product defect or product recall.

Alan should not consider that the audit has been completed until he fully assesses and understands the accounting and auditing impact which arises from the product defect and product recall.

Alan should also plan and carry out appropriate audit procedures in response to the potential additional risks of material misstatements identified. Alan should only sign the auditor's report when all the audit evidence has been obtained and evaluated and the appropriate audit conclusion is made.

Past Paper practice



HKICPA MC - Jun 2017 Qu7

Copper Mine Limited (“CML”) is a copper producer which operates its sole copper mine in Africa. You are the auditor of CML and are auditing CML’s financial statements for the year ended 31 December 2016. Subsequent to the year-end date, CML was found to be in breach of an environmental regulation which caused the whole copper mine to shut down. CML was subject to a significant amount of fines charged by the government. Because of the shutting down of the mine, CML was unable to deliver the copper to its customers on time and is now facing potential litigation claims filed by its customers.

The situation has impacted the audit in three aspects:

- a) Subsequent events - the fines payable to the government, the shutting down of the mine and the failure to deliver the copper to its customers are subsequent events (i.e. events which happened after the date of the financial statements but before the date of the auditor’s report).

Past Paper practice



HKICPA MC - Jun 2017 Qu7

- b) Non-compliance with laws and regulations - CML's breach of environmental regulations is an identified non-compliance with laws and regulations.
- c) Going concern - the shutting down of the copper mine and the series of claims from the customers are indicators to show that material uncertainty may exist which would cast significant doubt as to CML's ability to operate as a going concern.

Required

Choose any two from the above listed aspects, explain your responsibilities as the auditor of CML and propose audit procedures to respond to each of your chosen aspects. [Your answers to each aspect will score a maximum of 10 marks.]

(20 marks)

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer

Candidates should choose two of the following aspects to answer this question.

Subsequent events

In accordance with HKSA 560 *Subsequent Events*, the auditor should obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.

The auditor shall perform the following:

- Inquire of the management to obtain an understanding of these subsequent events.
- Review the relevant correspondences communicated by the government to CML and obtain an understanding about the subject of the fines and the duration of the suspension of the mine.

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer (Cont'd)

- Read minutes of the meetings of CML's owners and management that have been held after the date of the financial statements and inquire about matters discussed at any such meetings for which minutes are not yet available.
- In this case, documents about any internal inspection of the mine that might have been known by the management and/or any notification from the government made to CML regarding the possible breach in the environmental regulation during the year.
- Inquire of the management about their assessment as to whether these subsequent events should be adjusted in the financial statements and/or require additional disclosure (e.g. contingent liabilities).
- Inquire, or extend previous oral or written inquiries, of CML's legal counsel concerning the possible litigation and claims.
- Obtain evidence concerning the litigation and claims from CML's counsel (but only with the entity's permission). This may include correspondence with or confirmation letters from lawyers.

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer (Cont'd)

- 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.

Non-compliance with laws and regulations

When a non-compliance is identified, in accordance with HKSA 250 (Clarified) *Consideration of Laws and Regulations in an Audit of Financial Statements*, the auditor shall evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action.

As the auditor becomes aware of the non-compliance, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred.

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer (Cont'd)

The auditor shall obtain correspondences communicated between the government and CML to understand how long the mine will be shut down and to ask the management to see if there is any remedial action that CML can take in order to resume the mine's operation.

The auditor may consider it appropriate to consult with the entity's in-house legal counsel or external legal counsel about the application of the laws and regulations.

The auditor should evaluate the possible effect on the financial statements:

- (a) the potential financial consequences of non-compliance with laws and regulations in respect of the financial statements whether there are further fines, penalties or litigation claims;

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer (Cont'd)

- (b) whether the potential financial consequences require disclosure; and
- (c) whether the seriousness of the potential financial consequences would affect the presentation of the financial statements, for example, going concern.

During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention.

The auditor shall request management to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer (Cont'd)

Going concern

According to HKSA 570 (Revised) *Going Concern*, the auditor shall evaluate management's assessment of the entity's ability to continue as a going concern and management's use of the going concern assumption.

The auditor shall obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of its financial statements.

The auditor shall also conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast doubt on CML's ability to continue as a going concern.

The shutting down of the copper mine which is CML's sole activity has already cast significant doubt on CML's ability to continue as a going concern.

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer (Cont'd)

The auditor should perform the following procedures:

- Request management to make its assessment of CML's ability to continue as a going concern where this has not been done.

- Evaluate management's plans for future actions, such as:
 - any remedial action that CML can take in order to resume the operation of the mine;
 - any alternatives for CML to fulfil its obligations with its customers (such as to purchase copper from other suppliers and sell to customers);
 - any negotiations with the government which are in progress to resume the mine; and
 - any negotiations with the customers which are in progress to avoid litigations.

Past Paper practice

HKICPA MC - Jun 2017 Qu7



Answer (Cont'd)

- Evaluate the reliability of underlying data generated to prepare the forecast and determine whether there is adequate support for the assumptions underlying the forecast.
- Confirm the existence, terms and adequacy of borrowing facilities.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- Inquire of the entity's legal counsel regarding litigation and claims.
- Request written representations from management about plans for future action and the feasibility of these plans.



Audit reporting: HKSA 701 communicating key audit matters in the independent auditor's report



HKSA 700 (Revised)

Forming an Opinion and Reporting on Financial Statements

Basic elements of the auditor's report



Unmodified Opinion

An unmodified opinion is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Basic elements of audit report	Explanation
Title	The auditor's report must have a title that clearly indicates that it is the report of the independent auditor . This signifies that the auditor has met all the ethical requirements concerning independence and therefore distinguishes the auditor's report from other reports.
Addressee	The addressee will be determined by law or regulation, but is likely to be the shareholders or those charged with governance. [ie Board of directors]

Basic elements of the auditor's report



Basic elements of audit report	Explanation
Opinion paragraph	<p>Now presented first!</p> <ul style="list-style-type: none">• must identify the entity being audited, state that the financial statements have been audited, identify the title of each statement that comprises the financial statements being audited, refer to the summary of significant accounting policies and other explanatory notes, and specify the date or period covered• expresses an unmodified opinion on financial statements, shall use one of the following equivalent phrases:
Same Meaning	<p>The financial statements present fairly, in all material respects, ... in accordance with [the applicable financial reporting framework]; or The financial statements give a true and fair view of ... in accordance with [the applicable financial reporting framework].</p>

Basic elements of the auditor's report



Basic elements of audit report	Explanation
<p data-bbox="40 411 258 519">Basis for opinion</p> <p data-bbox="92 811 349 911">Affirmative statement</p> <p data-bbox="112 1096 324 1196">Same as previous</p>	<ul style="list-style-type: none"><li data-bbox="432 411 1875 696">• The basis for opinion paragraph must state that the audit was conducted in accordance with the HKSA's, and refer to the 'Auditor's responsibilities for the audit of the financial statements' section which describes the auditor's responsibilities under the HKSA's.<li data-bbox="432 772 1875 939">• The auditor must also state that they are independent of the audited entity, in accordance with the relevant ethical requirements relating to the audit.<li data-bbox="432 1011 1875 1178">• Finally, the auditor must state that they believe the audit evidence obtained is sufficient and appropriate to provide a basis for the audit opinion.

Basic elements of the auditor's report



Basic elements of audit report	Explanation
Going concern	<ul style="list-style-type: none">Where the auditor considers a material uncertainty related to going concern exists, this should be described in a separate paragraph headed 'Material uncertainty related to going concern'. [Refer to HKSA 570 (Revised)]
Key audit matters	<ul style="list-style-type: none">For the audit of listed entities, or where required by law or regulation, the auditor should include a 'Key audit matters' section.
Mandatory → Listed companies	
	<ul style="list-style-type: none">This section describes the matters that, in the auditor's professional judgement, are most significant to the audit.
Voluntary unlisted companies	

Refer to the back.



Basic elements of the auditor's report



Basic elements of audit report

Explanation

Other Information (HKSA 720(Revised))

For the audit of **listed entities or any other entity where the auditor has obtained other information**, an 'Other information' section should be included in the auditor's report. This section should include:

- a statement that **management is responsible for the other information**
- an identification of the other information obtained **before** the date of the auditor's report **(for listed entities, also the other information expected to be obtained after the date of the auditor's report) [NEW]**
- a statement that the auditor's opinion **does not cover** the other information
- a **description of the auditor's responsibilities for reading, considering and reporting on other information, and**
- where other information has been obtained, either a statement that the auditor has nothing to report, or a **description of any uncorrected material misstatement**

Refer to the back

Basic elements of the auditor's report



Basic elements of audit report

Explanation

Responsibilities of Directors and Those Charged with Governance for the Financial Statements

This section should describe **management's responsibility** including the following:

- The preparation of the financial statements in accordance with the **applicable financial reporting framework**; ie HKFRS and HKCO
- The **implementation of such internal control** as are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud.
- The assessment of the entity's **ability to continue as a going concern**, the appropriateness of the going concern basis of accounting and adequacy of related disclosures;

**HKSA 315
(Revised
2016)**

HKSA 570

Basic elements of the auditor's report



Basic elements of audit report	Explanation
Responsibilities of Directors and Those Charged with Governance for the Financial Statements	Reference shall be made to 'the preparation and fair presentation of these financial statements' (or 'the preparation of financial statements that give a true and fair view') where the financial statements are prepared in accordance with a fair presentation framework.
Auditor's responsibilities for the audit of the financial statements	The report must state that: <ul style="list-style-type: none">• the auditor's objectives - obtain reasonable assurance whether the financial statements as a whole are free from material misstatement, and to issue an auditor's report that includes the auditor's opinion; and

Basic elements of the auditor's report



Basic elements of audit report	Explanation
Auditor's responsibilities for the audit of the financial statements	<p>The report must state that:</p> <p>The report must also:</p> <ul style="list-style-type: none">• explain that misstatements can arise from fraud or error• describe the meaning of materiality• explain that the auditor exercises professional judgement and maintains professional scepticism throughout the audit• describe the auditor's responsibilities in an audit.



Basic elements of the auditor's report



Basic elements of audit report	Explanation
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this must be done in an additional paragraph titled 'Report on other legal and regulatory requirements' or otherwise as appropriate.
Name of the engagement partner	The name of the engagement partner should be identified.
Auditor's signature	The report must contain the auditor's signature , whether this is the auditor's own name or the audit firm's name or both.



Basic elements of the auditor's report



Basic elements of audit report	Explanation
Auditor's address	The location where the auditor practises must be included.
Date of the report	The report must be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion' on the financial statements.



HKSA 701 Communicating Key Audit Matters in the Independent Auditor's Report

How to determine KAM?



Objectives:

Determine key audit matters + Form an opinion on FS + Communicate those matters in the auditor's report

Determining KAM

- Select small number of most significant matters in the **current** audit requiring significant auditor's attention (not related to prior period's audits)
- Matters related to **higher** risks of material misstatements
- Matters that pose challenges to the auditors
- Matters relate to areas of **complexity and significant** management judgment in the FS ie involving expert
- Matters under HKSA 260 (Revised) – related party transactions / limitations on the group audit
- Difficult or contentious matters required for appropriate consultation

How to determine KAM? (Cont'd)



- Significant **qualitative** aspects – ie accounting estimates
- Significant events or Transactions that occurred during the period ie extensive discussion with management (ie **related party transactions** outside the normal course of business)

Purpose of the HKSA

- Enhance the **communicative value** of the auditor's report by providing **greater transparency** about the audit
- Additional information to **intended users** to understand the company and areas of significant management judgement - Users of FS may have expressed an interest in particular matters
- **Draw attention by the management and those charged with governance to the disclosure in the FS**

How to determine KAM? (Cont'd)



Be aware:

This HKSA is not substitute for:

- Disclosures in FS
- Modification of opinion under HKSA 705 (Revised)
(**Adverse Opinion** – still need to determine KAM)
(**Emphasis of Matter paragraphs and Other Matter paragraphs** cannot substitute KAM)
- Reporting the going concern issues under HKSA 570 (Revised)
- **Disclaimer of opinion** → No KAM Sector
- Disclosure of significant economic, accounting, regulatory, industry and developments affecting management's judgments and assumptions and affecting auditor's audit approach

How to determine “Significant” ?



What is significant?

By auditor’s judgment – both quantitative and qualitative. Consider the following:

- Importance to intended users
- Complexity of the accounting policies
- The nature and extent of audit effort
- The extent of specialized skills or knowledge
- The nature of consultations outside the engagement team
- Any control deficiencies
- Size and complexity of the entity, nature of its business and environment

Examples: long-term contracts involving revenue recognition / litigation / accounting estimates

Communicating Key Audit Matters



Display in a **separate section** of the auditor's report

Heading “Key Audit Matters”

Only on KAM – most significance in the audit of FS of the current period (only) ; and matters in the context of the audit of FS as a whole

Order of presentation for KAM can be any, dependent on auditor's judgement.

Description of Individual KAM :

- How much to describe ?
- Depend on **intended users**
- Additional information explaining why the matter was considered to be significant
- New or enhanced disclosures such as **key assumptions** used in accounting estimates, quantitative and qualitative estimate uncertainty
- **Going concern indicators** ie substantial operating losses, no-compliance with loans and agreements

Communicating Key Audit Matters



Description of Individual KAM (cont'd) :

Principal considerations leading the auditor to determine it is a significant KAM:

- Economic conditions affecting auditor's ability to collect audit evidence
- New or emerging accounting policies
- Changes in the entity's strategy or business model

Communication with Those Charged with Governance

HKSA 260 (Revised) – Communicate with those charged with governance on a timely basis

- Communicate preliminary views about KAM in the audit planning
- Opportunities to obtain understand the basis for the auditor's decisions in related to KAM

Relationship with modified opinions



MODIFIED OPINION	KAM
QUALIFIED	<p>Include the usual KAM section; AND Reference the Basis for Qualified Opinion in the KAM section.</p> <p><i>“In addition to the matter described in the Basis for Qualified Opinion section, we have determined the matters described below to be the key audit matters to be communicated in our report.”</i></p> <p>[Description of each key audit matter]</p>
ADVERSE	<p>Include the usual KAM section; AND Reference the Basis for Adverse Opinion in the KAM section.</p> <p><i>“In addition to the matter described in the Basis for Adverse Opinion section, we have determined the matters described below to be the key audit matters to be communicated in our report.”</i></p> <p>[Description of each key audit matter]</p>
DISCLAIMER	There must not be a KAM section.

Interaction with going concern



<p>If the use of the going concern basis of accounting is inappropriate</p>	<ul style="list-style-type: none">• An adverse opinion• A description of this circumstance in the <i>Basis for Adverse Opinion</i> section• Reference the <i>Basis for Adverse Opinion</i> in the KAM section
<p>Appropriate going concern basis + going concern indicators</p>	<ul style="list-style-type: none">• An unmodified opinion• A section with a new required heading Material Uncertainty Related to Going Concern, with a reference to the note in the financial statements that describes the material uncertainty, and a statement that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Interaction with going concern



	<ul style="list-style-type: none">• Reference the <i>Material Uncertainty Related to Going Concern</i> in the KAM section <p><i>“In addition to the matter described in the Material Uncertainty Related to Going Concern section we have determined the matters described below to be the key audit matters to be communicated in our report.”</i></p> <p>[Description of each key audit matter]</p>
<p>Appropriate going concern basis + going concern indicator + Inadequate or omitted disclosures</p>	<ul style="list-style-type: none">• A qualified or adverse opinion as appropriate• A description of this circumstance in the <i>Basis for Qualified/Adverse Opinion</i> section• Reference the <i>Basis for Qualified/Adverse Opinion</i> in the KAM section

Interaction with going concern



When the use of the going concern basis of accounting is **appropriate** but events or conditions were identified that may cast doubt on the entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that **no material uncertainty exists**

- An unmodified opinion
- Report as a KAM

Exclusion from Key Audit Matters



Circumstances in Which a Matter Determined to Be a Key Audit Matter Is **Not Communicated in the Auditor's Report**

- Law or regulation precludes public disclosure about the matter
- Matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits – very rare case

Matter giving rise to a modified opinion under **HKSA 705 (Revised)** or a **going concern indicator under HKSA 570 (Revised)**

- Alright not described in KAM but rather
- Report in according to HKSA and include reference to the **Basis for Qualified (Adverse) Opinion or the Material Uncertainty Related to Going Concern section**

KAM for Smaller Entities



For smaller entities it may not be so immediately existing of KAM

- If the entity is not complex, and it is **not** a high-risk audit engagement, therefore **no KAM**
- Smaller entities may not have any significant risks except the **mandatory risk of management override of controls** and the **reputable presumption of risk of fraud in revenue recognition**, not sure of KAM or not
- KAM are broader than “**significant risks**”
- KAM may just be areas where you spent most of your time during the audit.

Examples wordings of KAM



Goodwill

The Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the assessment process is **complex and highly judgmental** and is based on assumptions that are affected by expected future market or economic conditions, particularly those in [*Countries X and Y*]. As a result, our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the forecasted revenue growth and profit margins. We also focused on the **adequacy of the Group's disclosures** about those **assumptions to which the outcome of the impairment test is most sensitive**, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.

Examples of KAM



Valuation of Financial Instruments

The Group's disclosures about its structured financial instruments are included in Note X. The Group's investments in structured financial instruments represent [x%] of the total amount of its financial instruments. Because the valuation of the Group's structured financial instruments is **not based on quoted prices in active markets**, there is **significant measurement uncertainty** involved in this valuation. As a result, the valuation of these instruments was significant to our audit. The Group has determined it is necessary to use an entity-developed model to value these instruments, due to their unique structure and terms. We challenged the **rationale for using an entity-developed model** and discussed this with the Board of Directors, and we concluded the use of such a model was appropriate. Our audit procedures also included, among others, testing the controls related to the development and calibration of the model and confirming that the directors had determined it was not necessary to make any adjustments to the output of the model to reflect the assumptions that marketplace participants would use in similar circumstances.

Examples of KAM



Acquisition of XYZ Business

As described in Note X, in December 2017, the Group completed the **acquisition of ABC Business**. ABC Business was a division of a large private company. As of 31 December 2017, the Group has completed the initial acquisition accounting on a preliminary basis. The Group will finalise the initial acquisition accounting during 2018, and the amounts recorded as of 31 December 2017 could change. We focused on this transaction because it is material to the consolidated financial statements as a whole and the fact that values had not previously been assigned to the division as a standalone operation. In addition, determining the assumptions that underlie the initial acquisition accounting and the useful lives associated with the acquired intangible assets involves significant judgment given the nature of the [*manufacturing of industry*].

Practice Question - Marr



Question 1

You are an audit manager in Fender & Co, and have received a query from an audit senior on the subject of HKSA 701 *Communicating key audit matters in the independent auditor's report*.

'I have heard that this standard requires us to give several different auditor's opinions on each audit. I'm worried that we'll have to do a lot more audit work to obtain evidence for each key audit matter, and that it's pointless anyway because if these things were really important we would have included them in emphasis of matter paragraphs.'

Required

Respond to the audit senior's query, explaining the requirements of HKSA 701 where relevant.

(5 marks)

Practice Question - Marr

Question 2



You are an audit manager in Taylor & Co, a firm of Chartered Certified Accountants, responsible for the audit of Marr Co, with a year ended 28 February 20X4. The draft financial statements recognise profit for the year of \$11 million. The audit for the year end is nearing completion, and several matters have been highlighted for your attention by the audit senior, Xi Smith. The matters have been discussed with management and will not be adjusted in the financial statements:

- 1) In January 20X4 a major customer went into administration. There was a balance of \$2.5 million owing to Marr Co from this customer at 28 February 20X4, which is still included in trade receivables.
- 2) A court case began in December 20X3 involving an ex-employee who is suing Marr Co for unfair dismissal. Lawyers estimate that damages of \$50,000 are probable to be paid. The financial statements include a note describing the court case and quantifying the potential damages but no adjustment has been made to include it in the statement of financial position or the statement of profit or loss.

Practice Question - Marr



Question 2 (Cont'd)

Xi Smith has produced a draft auditor's report for your review, an extract of which is shown below:

Basis for opinion and disclaimer of opinion

We have performed our audit based on a materiality level of \$1.5 million. Our audit procedures have proven conclusively that trade receivables are materially misstated. The finance director of Marr Co, Rita Gilmour, has refused to make an adjustment to write off a significant trade receivables balance. Therefore, in our opinion the financial statements of Marr Co are materially misstated and we therefore express a disclaimer of opinion because we do not think they are fairly presented.

Practice Question - Marr



Question 2 (Cont'd)

Emphasis of Matter paragraph

Marr Co is facing a legal claim for an amount of \$50,000 from an ex-employee. In our opinion this amount should be recognised as a provision but it is not included in the statement of financial position. We draw your attention to this breach of the relevant HKFRS.

Required

Critically appraise the proposed auditor's report of Marr Co for the year ended 28 February 20X4.

Note. You are NOT required to re-draft the extracts from the auditor's report.

(10 marks)

Answer - Marr

Answer 1



The query contains three elements: the relationship between Key Audit Matters (KAMs) and the auditor's opinion, audit work, and emphasis of matter paragraphs.

Multiple opinions

HKSA 701 *Communicating key audit matters in the independent auditor's report* is clear that including KAMs does not mean expressing separate auditor's opinions on each issue. Rather, the auditor's opinion relates to the financial statements as a whole, and the KAMs are explanations of the matters of most significance to that audit. KAMs relate to the individual matters which underpin the auditor's opinion overall.

Audit work

The inclusion of KAMs in the auditor's report is the result of an attempt by the IAASB to make better use of the information obtained by the auditor during the normal audit process. Including KAMs in an auditor's report should therefore not involve 'a lot' more audit work. This is because the KAMs are matters which the auditor should already have considered and obtained evidence about.

Answer - Marr

Answer 1 (Cont'd)



In fact, the KAMs are merely the most significant matters which have been selected from those being communicated to those charged with governance at the end of the audit. Including them in the auditor's report should not involve obtaining any more audit evidence because this evidence should already have been obtained.

Emphasis of matter (EoM) paragraphs

The senior is correct to note the similarity between KAMs and EoM paragraphs. They both refer to matters already included in the financial statements, and neither modifies the auditor's opinion. However, there is a crucial difference between them: KAMs are included in every auditor's report where HKSA 701 applies, whereas EoM paragraphs are only included in particular circumstances. KAMs are part of the standard unmodified auditor's report, but an EoM paragraph modifies the auditor's report.

Answer - Marr

Answer 1 (Cont'd)



KAMs are defined as the 'matters of most significance to the audit', whereas EoMs are 'fundamental for users' understanding'. EoMs deal with exceptional matters that users must understand if they are to understand the financial statements. The EoM paragraph deals with the matter itself; KAMs do this, but will also focus on the audit process (and judgements made). HKSA 701 requires auditors to choose whether a matter is a KAM or requires an EoM paragraph (it cannot be both), depending mainly on its importance for users' understanding.

The point of KAMs is to provide users with additional information about the normal audit process, which should improve users' understanding of the entity's financial position and performance, and of the audit process. This is part of the general effort of regulators to raise audit quality, which is arguably vital if the audit profession as a whole is to remain of relevance to the modern world.

Answer - Marr

Answer 2



There are several problems with the draft auditor's report.

Layout

The draft report contains a paragraph entitled 'Basis for opinion and disclaimer of opinion'. HKSA's require two separate paragraphs here, headed 'Basis for Opinion' and 'Opinion'. The 'Basis for Opinion' paragraph is placed immediately before the 'Opinion' paragraph, and its heading reflects the type of opinion being given-hence 'Basis for Qualified Opinion', 'Basis for Adverse Opinion', and so on.

Wording of report

The paragraph states the materiality level used, which is not required by HKSA's. All that is needed here is a description of the scope of the audit.

Answer - Marr

Answer 2 (Cont'd)



The paragraph states that 'procedures have proven conclusively that trade receivables are materially misstated'. This is misleading. Audit procedures provide reasonable assurance, which is less than the absolute assurance implied by the words 'proven conclusively'.

The basis for modification paragraph should state the amount of the potential adjustment to receivables, along with its financial impact, referring to the relevant financial reporting standard.

The paragraph names the finance director, which is unnecessary and unprofessional. The statement that she 'refused to make an adjustment' is inflammatory and may leave the auditor open to legal action.

Answer - Marr

Answer 2 (Cont'd)



Opinion

An inappropriate auditor's opinion has been given here. At 23% of profit, any write-off of the receivable would be material. The draft report is therefore correct inasmuch as an unmodified opinion would be inappropriate because a material amount of the balance should be written-off.

However, the receivable is unlikely to be judged as pervasive to the financial statements, so the level of modification is wrong. Further, there has been no inability to obtain sufficient appropriate audit evidence, as would be implied by a disclaimer of opinion - as the draft report states, this is a material misstatement.

The opinion should be qualified on the grounds of there being a material misstatement.

Answer - Marr

Answer 2 (Cont'd)



Emphasis of Matter (EoM)

The use of an EoM paragraph is inappropriate. An EoM is used to refer to a matter which is already correctly disclosed in the financial statements, but which is in need of extra emphasis by the auditor. By contrast, here the EoM refers to a provision not included in the financial statements. In reality this is a misstatement.

The \$50,000 is not material, so the draft report is correct not to modify the opinion in this respect. The correct course of action would be to ask Marr Co to provide for this amount, and if they do not then keep track of it as an uncorrected misstatement. Although it is immaterial on its own, it may become material alongside other uncorrected misstatements.



HKSA 705 (Revised) ***Modifications to the Opinion in the Independent Auditor's Report***

HKSA 705 (Revised) Modified Opinion



The decision regarding **which type of modified opinion** is appropriate depends upon:

- (a) the materiality of the nature of the matter giving rise to the modification
- (a) the auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements

Pervasive is used to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any that are undetected due to an inability to obtain sufficient appropriate audit evidence.

HKSA 705 (Revised) Modified Opinion

Limitation on scope



Limitation on the scope of audit where (i) circumstances beyond the control of the entity; or (ii) circumstances relating to the nature or timing of the auditor's work

- Scope limitation may be **imposed by circumstances**
- Auditor would attempt to carry out **reasonable alternative procedures** to obtain sufficient, appropriate audit evidence to support an unqualified opinion.
- The auditor's report should describe the limitation and indicate the possible adjustments to the financial statements

HKSA 705 (Revised) Modified Opinion

Limitation on scope



Limitation on the scope of audit imposed by management

- When the terms of the engagement specify that the auditor will not carry out an audit procedure that the auditor believes is necessary
- The auditor shall **request that management** remove the limitation.
- The auditor shall **communicate** the matter to those charged with governance involved in managing entity
- Alternative procedures to obtain sufficient appropriate audit evidence
- A statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.
- Auditor withdraws from the engagement - communicate to those charged with governance

HKSA 705 (Revised) Modified Opinion

Limitation on scope



In our opinion, **except for** the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the consolidated financial statements give a true and fair view of the financial position of the Group as at 31 December, 20X1, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Qualified Opinion

The Group's investment in DEF Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the consolidated statement of financial position as at 31 December 20X1, and ABC's share of DEF's net income of xxx is included in ABC's income for the year then ended. **We were unable to obtain sufficient appropriate audit evidence** about the carrying amount of ABC's investment in DEF as at 31 December 20X1 and ABC's share of DEF's net income for the year because we were denied access to the financial information, management, and the auditors of DEF. **Consequently, we were unable to determine whether any adjustments to these amounts were necessary.**

HKSA 705 (Revised) Modified Opinion

Limitation on scope



We do not express an opinion on the consolidated financial statements of the Group. Because of the significance of the matter described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements. In all other respects, in our opinion the consolidated financial statements have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Disclaimer of Opinion

The Group's investment in its joint venture DEF Company is carried at xxx on the Group's consolidated statement of financial position, which represents over 90% of the Group's net assets as at 31 December 20X1. We were not allowed access to the management and the auditors of DEF Company, including DEF Company's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Group's proportional share of DEF Company's assets that it controls jointly, its proportional share of DEF Company's liabilities for which it is jointly responsible, its proportional share of DEF's income and expenses for the year, and the elements making up the consolidated statement of changes in equity and the consolidated cash flow statement.

HKSA 705 (Revised) Modified Opinion

Disagreement with management



Circumstances giving rise to such disagreement include the following:

Departure from **acceptable accounting practices** where there has been a failure to comply with Accounting Standards and the auditor does not concur.

ie Misapplication of the Selected Accounting Policies

- Inappropriateness or Adequacy of Disclosures in the Financial Statements
- Disagreement as to the **facts or amounts** included in the financial statements.
- Disagreement as to the **manner or extent of disclosure** of facts or amounts included in the financial statements.
- Failure to **comply with relevant legislation** or other requirements.

HKSA 705 (Revised) Modified Opinion

Disagreement with management



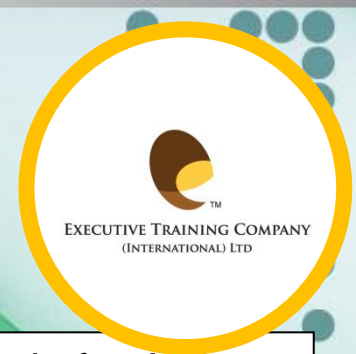
In our opinion, **except for** the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Qualified Opinion

The Company's inventories are carried in the statement of financial position at xxx. The directors have not stated the inventories at the lower of cost and net realizable value but have stated them solely at cost, which constitutes a departure from HKFRSs. The Company's records indicate that, had the directors stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

HKSA 705 (Revised) Modified Opinion

Disagreement with management



In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the consolidated financial statements do not give a true and fair view of the consolidated financial position of the Group as at 31 December 20X1, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). In all other respects, in our opinion the consolidated financial statements have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary DEF Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under HKFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had DEF Company been consolidated, many elements in the consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

HKSA 706 (Revised) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*



An **emphasis of matter paragraph** is used by the auditor to **highlight** an issue affecting the financial statements which the readers should know about but which does not give rise to a modified opinion.

Characteristics of EOM :

A paragraph included in the auditor's report that refers **to a matter appropriately presented or disclosed in the financial statements** that, in the auditor's judgment, is of such importance that it is **fundamental to users' understanding of the financial statements**.

- Include the paragraph within a **separate section of the auditor's report** with an appropriate heading that includes the term "Emphasis of Matter"
- **Clear reference to the matter** being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements.
- Indicate that the auditor's opinion is **not modified**

HKSA 706 (Revised) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*



There are various **examples** of circumstances where the auditor may consider it necessary to include an emphasis of matter paragraph:

An **uncertainty** relating to the **future outcome** of exceptional litigation or regulatory action

Early application (where permitted) of a new accounting standard (for example, a new Hong Kong Financial Reporting Standard) that has a pervasive effect on the financial statements in advance of its effective date

A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position

EOM Paragraphs and KAM

When HKSA 701 applies, the **use of EOM or are not a substitute for KAM.**

KAM in accordance with HKSA 701 may also be, in the auditor's judgment, **fundamental to users' understanding** of the financial statements.

HKSA 706 (Revised) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*



Other matter paragraph

There are specific circumstances where the Other Matter paragraph **shall** be used:

Where **prior period** financial statements were audited by the **predecessor auditor**.

Where **prior period** financial statements were **not audited** (note that this does not relieve the auditor of the obligation to obtain sufficient appropriate audit evidence on opening balances).

When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the predecessor auditor previously expressed.

An Other Matter paragraph **does not refer** to something that has been included as a key audit matter.



HKSA 720 (Revised) The auditor's responsibilities relating to other information

HKSA 720 (Revised)



In August 2015, HKICPA issued HKSA 720 (Revised) *The Auditor's Responsibilities to Other Information*. The key changes are a clarification of the definition of 'other information', an enhancement of the work carried out by the auditor and a requirement for including in the auditor's report a separate Other Information section when other information exists.

The auditor shall consider whether there is a **material inconsistency** between

- (i) the other information and the financial statements; and
- (ii) the other information and the auditor's knowledge obtained in the audit,

and respond and report appropriately under HKSA 720 (Revised).

HKSA 720 (Revised)



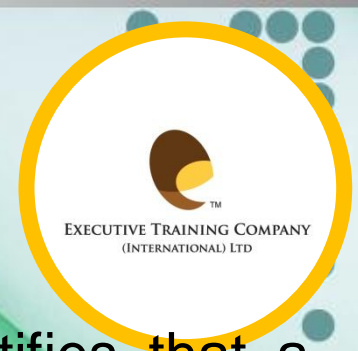
Other information is financial or non-financial information (other than financial statements and the auditor's report thereon) included in an entity's annual report.

Auditors have **no responsibility** to report that other information is properly stated because an audit is only an expression of opinion on the truth and fairness of the financial statements.

The auditors should give consideration to other information as **inconsistencies with the audited financial statements** may undermine their opinion.

The auditor shall **read** the other information and consider whether there are material inconsistencies.

HKSA 720 (Revised)



If, on reading the other information, the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor shall **discuss the matter with management** and, if necessary, perform other procedures to conclude whether:

- A material misstatement of the other information exists;
- A material misstatement of the financial statements exists; or
- The auditor's understanding of the entity and its environment needs to be updated.

HKSA 720 (Revised)



Revision needed to other information

If the other information is **not corrected** after communicating with those charged with governance, the auditor will consider the implication for the auditor's report or withdraw from the engagement.

The exact course of action will be down to the auditor's professional judgment.

The auditor may consider whether the rationale of management and those charged with governance for not making the correction implies a lack of management integrity. The auditor may wish to **obtain legal advice.**

HKSA 720 (Revised)

Audit Reporting



Where an **unmodified opinion** is expressed and the **other information is not materially misstated**, the standard unmodified Other Information section is placed after the Key Audit Matters section.

Other Information

The directors are responsible for the other information. The other information comprises the [information included in the X report, but does not include the financial statements and our auditor's report thereon.]

HKSA 720 (Revised)



Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

MC Exam Skills



1. Identify audit issues in the case
2. Count the marks
3. Use auditing wordings
4. Writing skills
5. Cross over standards
6. Practical audit procedures
7. Time management