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# Module C – Business Assurance



## Module Preparation Seminar – Agenda

- Identifying and assessing the risks of material misstatement at financial statement and assertion level (HKSA 315 (Revised 2016))
- Audit reporting: HKSA 701 communicating key audit matters in the independent auditor's report
- HKSA 720 (Revised) The auditor's responsibilities relating to other information



# HKSA 315 (Revised 2016)

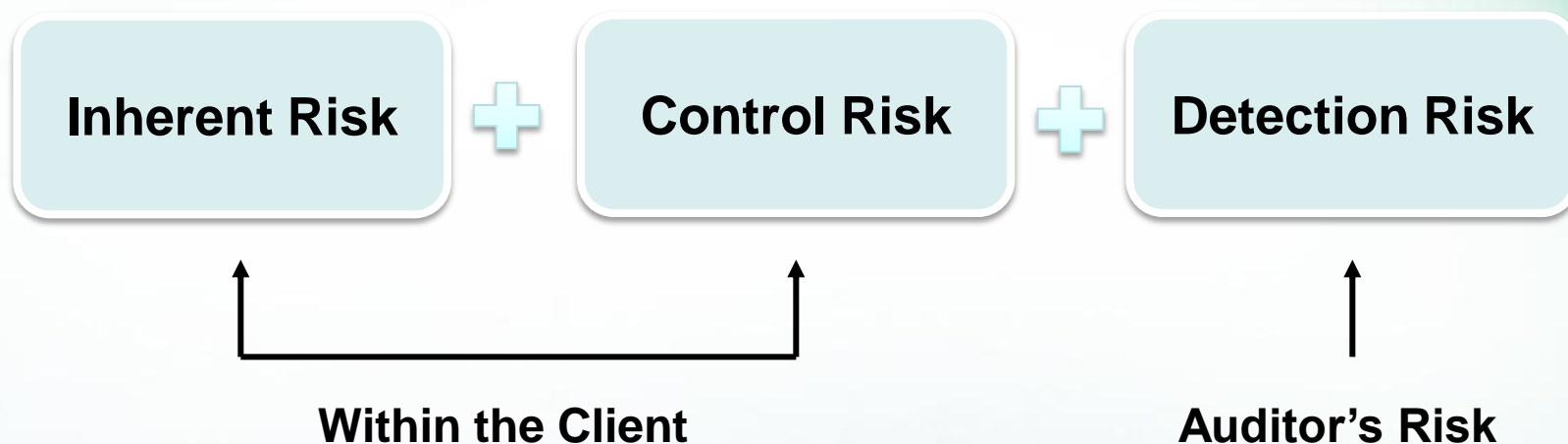
**Identifying and assessing the risks of material misstatement at financial statement and assertion level**

# MC – HKSA 315 (Revised 2016)



## Audit Risk - Definition & Components

It is “risk that auditor expresses an inappropriate audit opinion when the financial statements are materially misstated taken as a whole”



# MC – HKSA 315 (Revised 2016)



## Inherent Risk (“IR”)

- Refers to the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were **no related internal controls**.
- Example:
  - Industry environmental factors – competitiveness
  - Technological obsolescence or over-dependence on single product
  - Accounts which require expert valuations

# MC – HKSA 315 (Revised 2016)



## Control Risk (“CR”)

- Refers the risk that a misstatement that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by the accounting and **control systems**.
- If the company has good internal controls, there is a **high chance** that the control system will detect a material error.



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## Detection Risk (“DR”)

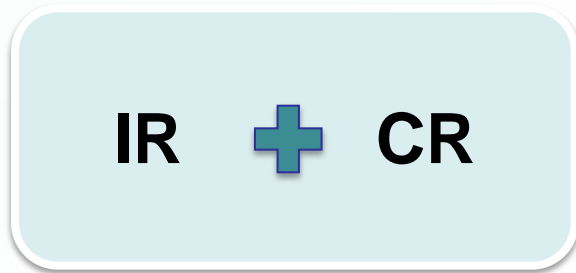
- Refers risk that the **auditor will not detect a material misstatement** that exists in an assertion where the audit procedures fail in its effectiveness. Auditor should amend his NET (Nature, Extent and Timeliness) of the audit procedures.
- Sampling risk and non-sampling risk are components of detection risk.
- Eg Incoming auditor – ie not familiar with the audit client

# MC – HKSA 315 (Revised 2016)



## Inverse Relationship

**Combined  
Assessment of risk**



**More Audit  
Work**



**Assertion Level**



**Perform Risk Assessment  
only on IR and CR**





# MC – HKSA 315 (Revised 2016)



## HKSA 315 (Revised 2016) Risk Assessment

Why revised the standard? As there are changes in HKSA 610 (Revised) related to internal auditors

### Risk Assessment Procedures and Related Activities

#### a) Inquiries of Management, the Internal Audit Function and Others within the Entity

- auditor can obtain information through inquiries with the **internal audit function**, if the entity has such a function
- Inquiries directed to **the risk management function**
- Inquiries directed to **information systems** personnel may provide information about system changes, system or control failures

# MC – HKSA 315 (Revised 2016)

## HKSA 315 (Revised 2016) Risk Assessment



### b) Inquiries of the Internal Audit Function

- the internal audit function is likely to **have obtained insight into the entity's operations and business risks**, and may have findings based on its work, such as identified control deficiencies or risks
- internal audit function provides information to the auditor regarding any **actual, suspected or alleged fraud**

### c) Considerations specific to public sector entities

- Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying **the risk of material non-compliance with applicable laws and regulations** and the **risk of deficiencies in internal control** over financial reporting.

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## d) Audit Evidence for Elements of the Control Environment

- The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies
- The auditor may also be able to use the work of the internal audit function to modify the **n**ature or **t**iming, or reduce the **e**xtent, of audit procedures

# MC – HKSA 315 (Revised 2016)

## HKSA 315 (Revised 2016) Risk Assessment



Requirement: (Must perform)

1. Identify and Assess the risks of material misstatements **at the (Overall) financial statement level** and at the **assertion level** for classes of transactions(P/L), account balances (B/S) and disclosures.
2. Determine risks that require **special audit consideration** and consider whether the controls are implemented (**“Significant Risks”**)

# MC – HKSA 315 (Revised 2016)

## HKSA 315 (Revised 2016) Risk Assessment



3. Evaluate the design of entity's controls and determine the implementation of the entity's controls
4. If is **not possible** or impracticable to reduce the risks of material misstatements at the assertion level to an acceptably low level with audit evidence obtained by substantive testing, then auditor should evaluate the design and implementation of the client's controls i.e. in a computerized system, lack of paper trail



# MC – HKSA 315 (Revised 2016)



## Collect Audit Evidence

- Main purpose = to obtain sufficient and appropriate audit evidence to support audit opinion
- Ways to collect audit evidence
  - **Risk Assessment**
  - Tests of Controls
  - Substantive Testing



# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Financial Statement Level – General

- Applying to the financial statement as a whole
- Able to reduce audit risk to an acceptably low level
- More pervasive to the financial statement at a whole
- **Affect many assertions**

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## Risk of material misstatement at Financial Statement Level – Factors to consider

\*\*\* Always related to management\*\*\*

- Risks from a weak control environment which includes management's attitudes to good internal control practice
- Management's attitude towards a good internal control
- Management's competence, integrity and experience

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## Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Unusual pressures** on management (i.e. plan to go public, bonuses ties to sales or profits)
- Nature of entity's business – risky Industry, market fluctuations
- Industry factors i.e. **Special regulations and reporting changes** (i.e. Listing companies, securities companies, insurance companies, banks)



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## Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Aggressive business strategies** – fast expansion, plenty of acquisition and mergers
- **Significant business risk**
  - Cannot focus on a specific risk
  - Concern about the client's going concern
  - Concern about fraud

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## HKSA 330 Responses to assessed risk – FS Level

- Reduce audit risk to an acceptability low level, auditor should determine overall responses to assessed risks of material misstatements at the financial statement level and **documentation is required**
- Consider Control Environment



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## HKSA 330 Responses to assessed risk – FS Level

### \*\*\*\* Use general audit strategy \*\*\*

For Example:

- Assigning more staff or more training for staff
- More supervision for staff
- Emphasizing to audit staff the need to maintain professional skepticism



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## HKSA 330 Responses to assessed risk – FS Level

- Collect more persuasive evidence and more procedures
- Using experts
- Incorporating more unpredictability into the audit procedures
- Change nature, extent and timeliness of substantive tests

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion Level

- **Not able** to reduce the risks of material misstatement to an acceptably low level with audit evidence obtained only from substantive procedures
- Refer to specific **classes of transactions, accounts balances**
- Risks arise from the particular characteristics of a class of transaction – **inherent and control risk**
- Identify controls that are likely to **prevent, detect or correct** material misstatements

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## Risk of material misstatement at Assertion Level – General

- Comprises of IR and CR (**Combined Assessment of the Risk of Material Misstatements**)
- Auditor would perform **tests of controls** to support the risk assessment

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion Level – Factors to consider

- Accounts likely to be susceptible to misstatements (i.e. required many adjustments in previous year's audit or accounts that include estimated amounts)
- **Complexity of underlying transactions** (i.e. financial instruments)
- Degree of judgement involved in determining account balances (i.e. provision for contingent liabilities and warranty expenses)
- Susceptibility of assets to loss or misappropriation

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion Level – Responses

- **Design and perform appropriate audit procedures to address** to the assessed risks of material misstatements at the assertion level and for each material class of transactions, account balances and disclosure.
- Determine risks that require special audit considerations and consider whether the controls are implemented
- Evaluate the design of entity's controls and determine the implementation of the entity's controls Vouching etc
- **Documentation of N(Nature) E(Extent) T(Timeliness)** \* of further audit procedures, linkage of those procedures with



# MC – HKSA 315 (Revised 2016)



## N – Nature of Substantive Testing

- Consider performing Substantive Testing only or both
- Tests of controls and substantive testing
- Type such as inspection, observation, inquiry etc
- Use **Substantive Approach** – Perform only substantive testing
- Use **Combined Approach** – Use both test of control and substantive testing



# MC – HKSA 315 (Revised 2016)



## E – Extent of Substantive Testing

- **Quantity** of a specific audit procedures to be performed
- Required judgment
- After consideration of materiality
- Higher Risk = increase extent
- Use sampling approach or not?

# MC – HKSA 315 (Revised 2016)



## T – Timeliness of Substantive Testing

- Perform further audit procedures **at an interim or at period end**
- Perform audit procedures before the period end – to identify significant matters at early stage of audit
- Higher risk = perform sub tests nearer to or at period end

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Existence** – Assets, liabilities, and equity interests do not exist at the Balance Sheet Date

#### Examples for increase risk:

- Multi-locations
- Assets held by third parties
- Assets that have special characteristics – require an expert to identify

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Completeness** – All assets, liabilities and equity interests that should have been recorded have not been recorded.

#### Examples for increase risk:

- Multi-locations, assets held by third party
- Wrong posting, off balance sheet items
- Understate of liabilities

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Accuracy, Valuation and Allocation** – Assets, liabilities, and equity interests are included in the financial statements **at inappropriate amounts** and any resulting valuation or allocation adjustments are not appropriately recorded

#### Examples for increase risk:

- Valuation subject to heavy estimate/ heavy market fluctuations/ expert's valuation / Heavy complex calculation is involved in the valuation i.e. manufactured goods – DM, DL, OH



# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements – Account Balance – Assertion Risk

- **Rights and Obligations** – The entity does not hold or control the rights to assets, and liabilities are not the obligations of the entity

#### Examples to increase risk:

- Subsequent events – title has been passed
- Many different contracts with many different terms
- Title is subject to specific HKAS

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Occurrence** – Transactions and events that have been recorded have not (1) **occurred** nor (2) pertain to the entity.

#### Example to increase risk:

- Sales occurred at year end
- Multiple sales – sales last for several years
- Invoice not with the client
- Consignment sales

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Completeness** – All transactions and events that should have been recorded have not been **recorded**

#### Examples to increase projects:

- Consignment sales
- Cutoff dates different for many companies
- No pre-numbering invoice
- No authorization n sales invoice

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Cutoff** – Transactions and events have been recorded in an **incorrect accounting period**.

#### Examples to increase risk:

- Transactions taken after year end
- Management's cutoff procedures not adequate

# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Income Statement – Assertion Risk

- **Accuracy** – Amounts and other data relating to recorded transactions and events have not been **recorded appropriately**.

#### Examples to increase risk:

- Complex HKAS
- Transactions terms have different interpretations
- Involve overseas accounting standards
- Require expert to interpret



# MC – HKSA 315 (Revised 2016)



## Risk of material misstatement at Assertion levels

### Statement of Financial Statements & Income Statement – Assertion Risk

**Classification:** transactions and events have been recorded in the proper accounts

**Presentation:** transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework

# MC – HKSA 315 (Revised 2016)



## Significant risks

**Significant risks** are **complex or unusual transactions** that may indicate fraud, or other risks or are unusual in their characteristics. Routine, and non-complex transactions are less likely to give rise to significant risk than unusual transactions.

**Significant risks** are those that require special audit consideration.

**Significant risks are often related to:**

- **Non-routine transactions** are transactions which occur occasionally due to either their size or nature.
- Risks of material misstatement may be greater for matters that require the use of **accounting estimates** which involve a degree of uncertainty.

# MC – HKSA 315 (Revised 2016)



## Scenario thinking:

Which Item?	Which assertions?
PPE	
Intangible Asset	
Inventories	
Receivables	
Contingent Liabilities	
Sales	

# MC – HKSA 315 (Revised 2016)



## Exam Techniques:

1. Which item in the FS affected?
2. Which assertions?
3. If figures are given , use them ie Analytical Procedures
4. Relationship between figures
5. What facts are given in the question?
6. Answer the question risk is low/normal or high?
7. How many marks?

# HKICPA - QPMC – Jun 2014 Q6



## Question

You are the auditor of Think Limited which is a furniture manufacturer with a factory in Dongguan, China. During the planning of the audit for the year ended 31 March 2014, you obtained the following financial information:

	2014 HK\$' million	2013 HK\$' million
Revenue	525	285
Costs of goods sold	330	242
Gross Profit	175	43
Property, plant and equipment	425	495
Accounts receivable	232	75
Accounts payable	155	105



# HKICPA - QPMC – Jun 2014 Q6



## Required:

a) Assess and explain the risk of material misstatement relating to the occurrence assertion of revenue for the year ended 31 March 2014.

(4 marks)

b) Discuss and propose the audit procedures for the occurrence assertion of revenue.

(6 marks)

# HKICPA - QPMC – Jun 2014 Q6



## Answer (a)

The risk of material misstatement relating to the **occurrence assertion** of Think Limited's revenue for the year ended 31 March 2014 is **high** as:

- The revenue significantly **increased 84%** from the prior year and there was no significant capital investment in Think Limited's property, plant and equipment to **increase its production capacity**.
- The gross profit margin **increased from 15% to 33%**. For manufacturing company, revenue should change in line with the cost of goods sold.
- The accounts receivable balances **increased to 3 times** of the same in the last year and the debtor turnover period (accounts receivable / revenue x 365 days) increased from 96 days to 161 days. It indicated that the revenue may be overstated by including non-existent debtors.

# HKICPA - QPMC – Jun 2014 Q6



## Answer (b)

The **audit procedures** for the occurrence assertion of revenue may include:

- Perform a **financial analysis** of the fluctuation of gross profit margin.
- Ask the management for the **reasons** for the fluctuation in gross profit margin with reference to the market situation.
- Perform an **industry comparison and analysis to document** whether the change in gross profit margin is in agreement with the current market trends and situation.
- Perform a **walk through test and control test** to ensure the effectiveness of internal controls implemented for the revenue cycle.

# HKICPA - QPMC – Jun 2014 Q6



## Answer (b) (Cont'd)

- Review whether the entity is following **HKAS 18 "Revenue"** and applies the revenue recognition policies consistently throughout the periods.
- **Discuss with the staff at the operational level** to ensure an understanding that the business operation procedure was correct and up to date and there are no key changes in the business operation procedures.
- Perform substantive procedures by **selecting samples** from the sales ledger and tracing them in goods delivery documents to ensure proper recording.
- **Direct confirmation** of customers to confirm the total sales amount for the year.



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



# Basic elements of the auditor's report



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

# Basic elements of the auditor's report



## Basic elements of audit report

## Explanation

### Basis for opinion

- 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**.

**Affirmative statement**

- The auditor must also state that they are **independent** of the audited entity, in accordance with the relevant **ethical requirements** relating to the audit.

**Same as previous**

- 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
<b>Going concern</b>	<ul style="list-style-type: none"><li>Where the auditor considers a material uncertainty related to going concern exists, this should be described in a <b>separate paragraph</b> headed '<b>Material uncertainty related to going concern</b>'. [Refer to HKSA 570 (Revised)]</li></ul>
<b>Key audit matters</b>	<ul style="list-style-type: none"><li>For the audit of <b>listed entities</b>, or where required by law or regulation, the auditor should include a '<b>Key audit matters</b>' <b>section</b>.</li></ul>
<b>Mandatory</b> → <b>Listed companies</b>	
	<ul style="list-style-type: none"><li>This section describes the matters that, in the auditor's professional judgement, are most significant to the audit.</li></ul>
<b>Voluntary unlisted companies</b>	<div data-bbox="1321 1096 1779 1172" style="border: 1px solid black; padding: 5px; text-align: center;"><b>Refer to the back.</b></div>





# 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
<p data-bbox="42 382 459 735"><b>Responsibilities of Directors and Those Charged with Governance for the Financial Statements</b></p> <div data-bbox="79 772 396 968" style="border: 1px solid black; padding: 5px; margin: 10px 0;"><p data-bbox="117 791 357 953"><b>HKSA 315 (Revised 2016)</b></p></div> <div data-bbox="90 1118 388 1196" style="border: 1px solid black; padding: 5px; margin: 10px 0;"><p data-bbox="121 1136 357 1182"><b>HKSA 570</b></p></div>	<p data-bbox="459 382 1889 499">This section should describe <b>management's responsibility</b> including the following:</p> <ul data-bbox="459 499 1889 1290" style="list-style-type: none"><li data-bbox="459 499 1889 735">• The preparation of the financial statements in accordance with the <b>applicable financial reporting framework</b>; ie HKFRS and HKCO</li><li data-bbox="459 735 1889 1021">• The <b>implementation of such internal control</b> as are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud.</li><li data-bbox="459 1021 1889 1290">• The assessment of the entity's <b>ability to continue as a going concern</b>, the appropriateness of the going concern basis of accounting and adequacy of related disclosures;</li></ul>

# 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 <b>'the preparation and fair presentation of these financial statements'</b> (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"><li>• the auditor's objectives - obtain <b>reasonable assurance</b> 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</li></ul>

# Basic elements of the auditor's report



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



# Basic elements of the auditor's report



Basic elements of audit report	Explanation
<b>Other reporting responsibilities</b>	If the auditor is <b>required by law to report</b> on any other matters, this must be done in an additional paragraph titled 'Report on other legal and regulatory requirements' or otherwise as appropriate.
<b>Name of the engagement partner</b>	The <b>name of the engagement partner</b> should be identified.
<b>Auditor's signature</b>	The report must contain the <b>auditor's signature</b> , 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
<b>Auditor's address</b>	The location where the auditor practises must be included.
<b>Date of the report</b>	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
<b>QUALIFIED</b>	<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><b>[Description of each key audit matter]</b></p>
<b>ADVERSE</b>	<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><b>[Description of each key audit matter]</b></p>
<b>DISCLAIMER</b>	There must <b>not</b> be a KAM section.



# Interaction with going concern



<p>If the use of the going concern basis of accounting is <b>inappropriate</b></p>	<ul style="list-style-type: none"><li>• An adverse opinion</li><li>• A description of this circumstance in the <i>Basis for Adverse Opinion</i> section</li><li>• Reference the <i>Basis for Adverse Opinion</i> in the KAM section</li></ul>
<p>Appropriate going concern basis + going concern indicators</p>	<ul style="list-style-type: none"><li>• An unmodified opinion</li><li>• A section with a new required heading <b>Material Uncertainty Related to Going Concern</b>, with a reference to the <b>note</b> 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.</li></ul>



# Interaction with going concern



	<ul style="list-style-type: none"><li>• Reference the <i>Material Uncertainty Related to Going Concern</i> in the KAM section</li></ul> <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><b>[Description of each key audit matter]</b></p>
<p><b>Appropriate going concern basis + going concern indicator + Inadequate or omitted disclosures</b></p>	<ul style="list-style-type: none"><li>• A qualified or adverse opinion as appropriate</li><li>• A description of this circumstance in the <i>Basis for Qualified/Adverse Opinion</i> section</li><li>• Reference the <i>Basis for Qualified/Adverse Opinion</i> in the KAM section</li></ul>

# 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*].

# 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)

# 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.**



# 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.



# 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 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