Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Quality Assurance
Annual Report 2009

Content

Foreword

Fellow members

I am pleased to bring to you a report on the activities of the Quality Assurance Department of the Institute during 2009. In introducing this report I would like to highlight some key points that are included in it.

The report provides a summary of the work carried out under the practice review and professional standards monitoring programmes and highlights some of the more common findings that we identified in the course of our reviews. We have also used the findings from our reviews to provide feedback to members and Practices on areas that they need to pay particular attention to in auditing or preparing financial statements. We have communicated these matters through technical alerts, forums and meetings.

In 2009 we completed the first cycle of practice reviews of listed company auditors, well within the three year target that we set in 2007 when the revised practice review programme got under way. We also reviewed a number of auditors of regulated entities. This confirms our commitment to ensuring that auditors of listed and regulated entities are reviewed as a priority.

The Institute is committed to upholding the quality of audit and financial reporting in Hong Kong and we believe that our thorough and pragmatic quality assurance programmes are effective contributors to that aim. We will continue to ensure that our activities are carried out in a robust and appropriate manner and that they remain at the leading edge of auditor regulation and quality assurance.

In 2010 we will be visiting a number of Practices for the second time. We have also, over the last two and a half years, made considerable efforts to communicate weaknesses that we have found in auditing and financial reporting and to ensure that our expectations of quality work and compliance with professional standards are understood. We will not be changing the way we approach practice review but we, with the support of the Practice Review Committee, will be expecting to see that positive steps have been taken to address previously reported and published areas of weakness.

Finally, I would like to thank the members and Practices that have been subject to review. They have almost without fail co-operated fully with our reviewers and have demonstrated a positive attitude to improving quality. I have received positive feedback on the conduct of reviewers and the usefulness of reviews. I firmly believe that in addition to fulfilling our responsibilities as regulators we can use the review programmes in a positive manner to encourage and assist members continue to carry out their professional work to the highest standards.

Chris Joy
Executive Director, Hong Kong Institute of CPAs
March 2010

What do we do

The work of the Quality Assurance Department ("QAD") of the Institute follows two tracks, practice review and professional standards monitoring.

Practice review is a quality assurance programme that monitors the provision of audit and other related assurance services by firms, corporate practices and individual practising certificate holders in Hong Kong ("Practices"). The Institute introduced practice review in 1992 under the authority and powers granted by the Professional Accountants Ordinance ("PAO") and the programme was revamped in 2006. The results of the reviews carried out on Practices by the QAD are reported to the Practice Review Committee ("PRC" or "Committee") which is the Committee responsible for exercising the powers given to the Institute as the regulator of auditors in Hong Kong under sections 32A to 32I of the PAO. By law, at least two thirds of the Committee must hold practising certificates. The practising members of the Committee are drawn from the full spectrum of audit firms. Non-practising members are also included in the Committee to bring an additional level of independence to Committee decisions on the quality of work carried out by Practices subject to review. Please refer to Annex for the composition of the PRC.

The second stream of work carried out by the QAD is to review published financial statements of listed companies. It is carried out under the Institute's professional standards monitoring programme ("PSMP") which has been in operation since 1988.

With more than 20 years of experience, PSMP has been developed as a comprehensive and extensive financial reporting review programme carrying out regular reviews of financial statements which are selected from a population of all listed companies in Hong Kong. It is supported by the technical expertise of Professional Standards Monitoring Expert Panel ("PSMEP" or "Panel") and external reviewers from Big Four and medium sized practising firms. Significant or complex issues arising from reviews of published financial statements will be referred to Panel members for their view on the application of professional standards and advice on how to formulate questions to members and assess members' responses. Through this process, Panel members through their knowledge and expertise in financial reporting and auditing assist the QAD in reaching an appropriate resolution of the case.

The results of both programmes provide valuable content for the Institute's member learning and development activities. The direct interaction with members on auditing and financial reporting matters is a very effective way to give advice and assistance on the application of professional standards. Both programmes will remain a critical part of the Institute's role to support members and serve the wider public interest of Hong Kong by ensuring that the quality of auditing and financial reporting is maintained and enhanced.

What have we changed since last year

As part of the Institute's changes in its governance and operational structure, some changes have been brought in to the operation and oversight of the programmes:

Standards and Quality Accountability Board

The Standards and Quality Accountability Board ("SQAB") was set up in January 2009. The SQAB has assumed the role of the practice review oversight board to exercise independent oversight over the practice review programme. The SQAB has responsibility for oversight of the activities of the QAD and ensures that activities are being carried out in accordance with strategies and policies determined by Council and in the public interest. The SQAB receives and reviews yearly plans and budgets and regular progress reports from management of the Institute and reports to Council on their observations and views in relation to divisional performance and operations. Please refer to Annex for the composition of the SQAB.

Professional Standards Monitoring Expert Panel

The Panel was formed in 2009 and is comprised of individuals with in-depth knowledge of accounting and auditing standards who have extensive practical experience in auditing or preparing financial statements of listed companies as well as representative from other regulatory body. Panel members are drawn from Big Four firms, medium-sized practitioners, non-practising members working in listed and unlisted companies and representative of Hong Kong Exchanges and Clearing Limited ("HKEX"). Please refer to Annex for the composition of the Panel.

What have we achieved in 2009

Practice review programme

In 2009, the practice review programme hit a new record of reviewing more than 120 Practices. Reviews undertaken included all of the Big Four, other Practices that audit listed and regulated entities and a number of other small and medium sized Practices.

The PRC met on eleven occasions in 2009 and reviewed reports covering 142 Practices. The PRC concluded that 37 cases should be closed without requiring any follow up action. In 98 cases, Practices were required to submit a status report to the QAD on actions taken in response to the findings within a requested period of time and 7 cases would require a follow up visit to assess the effectiveness of remedial action taken by the Practices. In addition to the 142 "first time" practice reviews, 40 follow up cases (including 7 follow up visits) were reported to the PRC up to its meeting in December 2009.

None of the reviews that took place in 2009 has resulted in referral to the Institute's disciplinary process. This was in line with the PRC's intention to give Practices time to improve on identified weaknesses in procedures and conduct of audit work except in the most serious cases, where disciplinary actions will be a "last resort" rightly reserved for those Practices that have "serious" practice review findings of non-compliance with professional standards or "serious" levels of technical incompetence.

By the end of 2009, the QAD has completed the first review cycle of all Practices with listed clients which is more than six months ahead of the timeframe we had committed to when commencing the practice review programme in 2007.

The second version of the electronic self-assessment questionnaire ("EQS"), which is used to assist in the selection of Practices for review, was rolled out in August 2009 and was made available to approximately 3,100 Practices. This version is relatively shorter and simpler compared with the initial version in 2007. By early 2010, the completion rate of the self-assessment questionnaire was nearly 100 percent.

Professional standards monitoring programme

Approximately 140 reviews (i.e. initial reviews and follow up reviews on auditors' responses) were carried out in 2009. More than 105 letters were issued to Practices and 79 cases were closed.

Three cases involving more significant departure from relevant accounting standards were referred to the compliance department of the Institute in 2009 and concluded by the Professional Conduct Committee ("PCC") in the same year.

What is our review process

Practice review programme

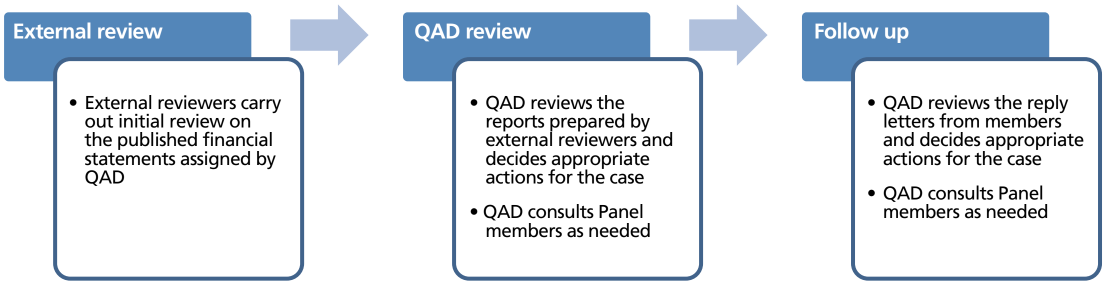
Practices are selected for practice review according to their risk profile. Practices selected for review are normally advised of the visit date several weeks before the visit date and requested to provide certain information in advance of the visit. The QAD makes a preliminary assessment on documents provided before on-site review.

The scope of each review includes obtaining an understanding of the Practice's system of quality control, assessing the effectiveness of the system in achieving compliance with HKSQC 1 and assessing compliance with professional standards in the operation of quality control policies and conduct of audit work.

Practice reviewers enquire, discuss and agree findings with the Practices in respect of matters identified through the course of the review. A formal presentation of the significant matters, which have already been discussed in detail during the course of the review, will be made in the exit meeting.

After the exit meeting, the QAD sends each Practice a draft report that communicates the findings of the review. The Practice is asked to provide a formal written response to the matters raised in the draft report. The QAD is responsible for drawing conclusions on the review and making recommendations to the PRC for consideration and decision. Each Practice is sent a formal notification of the PRC decision that may include specific requests to ensure appropriate steps are taken to address weaknesses and shortcomings identified by the review. The QAD monitors the progress of the follow up actions undertaken by the Practices at the direction of the PRC.

Professional standards monitoring programme



A risk-based approach is used to select published financial statements for review by external reviewers, e.g. financial statements of newly listed companies, companies which have significant changes in share prices or companies with change in auditors.

The programme places particular emphasis on the initial application of new or revised standards by companies. The review coverage does not include the financial statements on which qualified/ modified audit reports were issued, to avoid duplication with the review programme of the Financial Reporting Council ("FRC"). The reviews also do not cover compliance with disclosure requirements of the Listing Rules which is carried out by HKEX.

All findings and educational points noted by the external reviewers are reviewed and assessed by the QAD. Follow up action on points raised by the reviews may include issuing enquiry letters to seek members' explanation on the issues noted and issuing letters pointing out areas for improvement. If there is no significant issue identified in the initial review, no letter will be issued and the case will be closed.

On the basis of responses received to initial enquires, a decision is made on whether the case can be closed or requires further enquiries. Panel members are consulted if there are significant, complex or controversial issues identified during the review process.

If, at the end of the process, there is an unresolved and significant departure from professional standards, a complaint may be raised for consideration by the PCC. As reviews are primarily of listed company financial statements, these cases may ultimately be referred to the FRC.

What have we done to help our members

While practice review in particular has a primary regulatory function, the work of the QAD is also used to assist members to improve adherence to professional standards and raise their quality of auditing and financial reporting in a positive and constructive way. Common issues found under the review programmes and members' views on practice review were communicated to members through different channels:

a) An article was published in July 2009 APlus containing contributions from several practitioners in small and medium sized audit firms which underwent their first practice reviews under the revamped practice review programme. The practitioners shared their views on how practice review helped them to improve working practices and procedures and address weaknesses in compliance with professional standards.

b) The QAD hosted three forums in July and August 2009 that drew more than 900 attendees. The forums covered development in the practice review programme and some of the common issues identified by reviewers. The forums also looked at some practical ways in which Practices can address the challenges of complying with professional standards, and provided suggestions in respect of the improvements of quality control policies and procedures.

c) The Quality Assurance section of the revamped Institute's website which was launched in September 2009 (http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/) aims to provide more up-to-date information and enhance the transparency of the process of both review programmes.

d) At the invitation of the Society of Chinese Accountants and Auditors, the Institute's Executive Director of Standards & Regulation participated in two forums on practice review that took place in late September and drew a total of more than 300 attendees.

e) Findings from the reviews have also been used by the Institute's technical team in providing relevant support for members through the ongoing TUE training sessions.

f) Queries are emailed to the QAD at the usual contact of qualityassurance@hkicpa.org.hk. The quality assurance team replied to over 200 emails in 2009 in respect of the practice review programme.

Looking forward, the QAD is aiming to carry out more supporting activities to members in 2010. For example, the QAD has started to issue Financial Reporting and Auditing Alerts from January 2010 which summarise the findings identified from reviews of financial statements of listed companies under the PSMP. We hope that members will benefit from these findings in preparing or auditing financial statements and from our continuous supports to members as mentioned above.

Findings and educational points from practice review programme

This section provides a summary of major issues identified from the reviews carried out in the period covered by this report. The issues raised are either considered to be individually significant or common to a number of Practices, and should be of interest to all Practices involved in auditing and may assist them in revising their audit approach and procedures where they recognise the situations as potentially applying to them.

Section I – Quality control procedures

We were pleased to note that, during the year, steady progress has been made across most Practices in developing quality control procedures and improving their audit methodology. However, there are still a number of common issues in respect of quality control procedures, many of which have been raised in our previous reports. The most commonly occurring or significant are set out below:

1. *Appropriate quality control policies and procedures*

   When practitioners decide to adopt "A Guide to Quality Control" issued by the Institute to meet all the requirements of HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*, they should consider how the guide should be tailored for their circumstances. The guide is not a mandatory document that has to be applied word for word. The guide is intended to help practitioners to understand and efficiently apply HKSQC 1 and therefore they should consider the application of quality control in the context of their own practices and tailor the guide accordingly.

   Other practitioners developed their own quality control policies and procedures that did not address all requirements of HKSQC 1. Practitioners are reminded that policies and procedures adopted need to be appropriate to the size and operating characteristics of the Practice while addressing the principles of HKSQC 1 and that the QAD assess and review a Practice against the requirements of HKSQC 1.

2. *Monitoring function*

   a) *Implementation of monitoring function*

      Although HKSQC 1 has been effective since 2005, some small Practices still have not implemented a monitoring function. The most common explanation given is that they find it difficult to carry out monitoring due to the limited internal resources. In our previous report, we have emphasised the importance of monitoring and listed out various possible ways to assist practitioners in carrying out their monitoring function. We recognize the challenges that face small Practices with constrained resources, however, HKSQC 1 applies to all Practices, there is no exemption on the grounds of size or nature of client base.

b) *Documentation*

In some cases, practitioners informed practice reviewers that monitoring reviews have been performed but there was no documentation to evidence such review. Proper documentation of procedures and findings, and the communication of those findings are necessary and Practices should document the results of reviews of quality control procedures and the completed audit engagement to evidence that the monitoring function has been properly carried out.

c) *Assessment of quality control system within the Practice*

Monitoring reviews should cover both completed engagement file reviews and a review of compliance with the Practice's overall quality control policies and procedures. Practice review focuses on a Practice's own approach to quality control and therefore it is crucial that monitoring programmes are fully comprehensive.

d) *Selection of completed engagements for review*

A number of engagement reviews addressed fairly small or dormant clients even when there were high-risk engagements, e.g. listed and regulated clients, within the Practices' client portfolios. The QAD considers that it would be more meaningful and helpful to include higher risk client in the sample for engagement file inspection if the Practice has that type of client.

e) *Follow-up*

We saw a few cases where the Practices had carried out a monitoring review and recommendations had been proposed by the monitor and yet there was no follow-up action or assessment on whether the recommendations are properly addressed. Practices are reminded that taking action on findings identified by the monitor is as important as the monitoring process.

3. *Acceptance and continuance*

Practices normally use standard client acceptance and continuance checklists from the guide to evidence that an assessment had been carried out before accepting a new/ recurring client. However, some practitioners were unable to show us how and what they had considered during their assessment e.g. consideration of audit implications of a potential buyout of their existing client or Practice's resources and time to complete a difficult audit engagement with tight deadlines. Practices must avoid completing a checklist in a mechanistic manner without giving the issues proper consideration.

The decision to accept or retain a client is crucial because of the potential risk of being associated with certain clients, in particular for engagements such as IPO, listed or regulated entities where there is a higher risk to Practices in the way of potential consequences or exposure. Practitioners should consider whether they have the capabilities, time and resources to perform these audits e.g. any experience and competence to understand and handle complex business transactions and accounting issues which commonly exist in these entities. Extra caution must be exercised at client acceptance when there are qualified audit opinions or a regular change of auditors as such circumstances could be indicative of potential engagement risks. Accepting a "wrong" client can be costly to an audit firm as it could potentially cause a loss of reputation to the Practice, financial loss or even lead to disciplinary sanctions if problems occur with the audit. In short, client acceptance decisions are increasingly important due to continued fee pressure and litigation risk, which make it essential that Practices carefully consider the potential benefits and costs of association with prospective clients.

4. *Partner rotation and engagement quality control review*

Instances were identified where some Practices did not follow the requirements of partner rotation and engagement quality control review ("EQCR") for listed engagements. Under current professional standards, engagement partners of a listed client should be rotated after a pre-defined period, normally no more than seven years, and an EQCR must be conducted on all listed audit engagements. Practices with listed clients should ensure they have sufficient resources to implement a partner rotation policy and have personnel with sufficient technical expertise and experience to carry out an effective EQCR. Practices should also consider if EQCR is necessary for regulated entities and special engagements which are usually subject to higher risks and compliance with additional rules and requirements of other regulatory bodies.

5. *Independence*

Some smaller Practices have audit fees from large clients, e.g. IPO and listed clients, that form a significant portion of the total revenue of the Practice. Fee pressure and the importance of the client relationship may impair the Practice's independence in appearance. Practices should identify, evaluate and address any potential threats to independence and apply appropriate safeguards to effectively mitigate them. If no appropriate safeguards can be put in place, the Practice should consider not accepting or resigning from the engagement.

Section II – Audit methodology and procedures

1. *Customised audit methodology*

Some Practices adopted the "Audit Practice Manual" issued by the Institute as their audit methodology without tailoring it to the Practice or engagement specific circumstances. In some cases, audit checklists and programmes were not completed in an appropriate manner. For some other Practices, audit procedures were developed in-house but the procedures have not been revised to fully embrace the changes that came in with "new" auditing and accounting standards effective in 2005 and thereafter. Standard audit programmes and checklists are useful tools to promote consistency in the quality of engagement performance and assist in ensuring the application of the requirement of standards. However, the purpose of adopting standard audit programmes and checklists cannot be achieved if they are not updated in line with changes to professional standards.

Only completing standard audit programmes and checklists may not fulfill all audit documentation requirements. Comments or specific references to working papers are sometimes required to elaborate the thought process or details of procedures performed. The nature, extent and timing of audit procedures performed should be documented to support that the audit steps indicated in the programmes were properly carried out and completed.

2. *Audit planning and risk assessment*

Audit planning and risk assessment procedures were areas where the QAD considered most Practices required improvements. In a number of cases no or insufficient audit planning was performed. The deficiencies were mainly related to inadequate planning in relation to risk assessment procedures and lack of documentation of responses to assessed risks as determined under HKSA 330 *The Auditor's Procedures in Response to Assessed Risks*. There were instances that subsequent changes were made to the planned procedures but these were not revised in the audit plan.

An audit plan should include a description of the planned risk assessment procedures as determined under HKSA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. Practice reviewers noted that some Practices did not perform or document the following procedures to obtain an understanding on client's business and its environment for risk assessment purpose:

- discussion and enquiry with management;
- understanding of information technology environment and evaluation of its impact on the audit;
- understanding of internal controls;
- evaluation of the design and implementation test of key controls; and
- planning analytical review

Practitioners are reminded that the current standards require this risk assessment process to be undertaken regardless of the size and complexity of their clients but the documentation required for a small client can be relatively simple. Immediate default to a "substantive" audit approach for a small company with simple operations is not a reason for not going through this process.

Practitioners were also advised to keep themselves current with all financial reporting standards in order to ensure that audit risks were properly identified at planning stage and throughout the audit. Instances were identified where some practitioners failed to identify certain risks or misstatements in financial statements arising from inappropriate accounting treatment by their clients, in particular, issues with the application of relatively complicated accounting standards such as HKFRS 3 *Business Combinations* and HKAS 39 *Financial Instruments: Recognition and Measurement*.

3. HKSA 240 The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements

Some practitioners still do not understand the requirements of HKSA 240 and therefore did not update their audit approach to carry out necessary procedures. This resulted in cases where no fraud risk assessment was performed or a simple conclusion was drawn by stating that "no fraud was identified by management" or "no fraud was noted during the course of audit" without any proper assessment.

HKSA 240 established essential procedures and guidance on the auditor's responsibility to consider fraud in an audit of financial statements and expands on how the standards and guidance in HKSA 315 and HKSA 330 are to be applied in relation to risks of material misstatement due to fraud. The QAD often questioned the sufficiency of work performed in fraud risk assessment, for example:

- conduct enquiries with management, those charged with governance (e.g. audit committee) and engagement team which focus on possibility of potential fraud;
- determine response to address the risk of fraud on revenue recognition;
- in cases that auditors concluded that the risk of fraud on revenue recognition is not applicable in the circumstances of the engagement, the reason for that conclusion should be documented;
- design and perform audit procedures to respond to the risk of management override of controls, including test appropriateness of journal entries and adjustments; review accounting estimates for bias and understand the business rationale for significant transactions; and
- obtain written representations from management relating to fraud.

The QAD expects Practices to document fraud risk assessment, i.e. procedures to consider fraud in an audit of financial statements, details of work they have carried out and the results of the procedures performed.

4. *Subcontracting arrangements*

Some Practices subcontract elements of the audit work to other Practices or individuals either in or outside Hong Kong when they have limited internal resources. As mentioned in our report last year, there is nothing wrong with this in principle if it addresses gaps in resources or skills that would otherwise exist. However, practitioners need to bear in mind that subcontracting an audit does not reduce the responsibility of the Practice for the audit opinion on the audited financial statements. Instances were noted where practitioners did not retain the subcontractor's audit work papers, did not have sufficient audit evidence in their own files to support the audit opinion, did not know the extent of audit procedures performed by the subcontractors and had not assessed whether subcontractors had obtained sufficient audit evidence for work they handled. Practitioners are strongly reminded that they retain full responsibility for all aspects of the audit and must ensure control and management of the audit process and that evidence of control and supervision over the subcontractor's work should be documented. Practices should ensure subcontractors understand and comply with all policies and procedures of the Practice, and ethical requirements under HKSQC 1 and Code of Ethics. A formal engagement letter is usually a good starting point to avoid any misunderstandings over roles, responsibilities, ownership or retention arrangements regarding the work papers and documents.

5. *Group audit arrangements*

Issues in relation to the use of other auditors on group audits were identified during the year. Instances were identified where Practices did not assess the competence of the other auditors and adequacy of audit work performed by them before placing reliance on them. For example, when other auditors are not a member firm of the Practices where the use of audit methodologies and accounting standards might differ materially, Practices should give an appropriate consideration to their competency and evidence their assessment on the level of support over the work performed by other auditors in files.

We also noted instances in which clearance opinions received from other auditors were not signed off in accordance with the group instructions issued by the Practices. For example, the opinions were signed off in accordance with local GAAP rather than that applicable for group reporting. In these situations, we would have expected an assessment by the Practice, the group auditor, of the impact of this divergence to have been evidenced on file. Practices should ensure they give appropriate consideration to the implications of other auditors failing to report in accordance with the group instructions.

Practitioners should refer to the new HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* issued in September 2009. This standard is particularly helpful as it brings a lot of best practices on group audits into auditing standards for application by all auditors.

6. *HKSA 620 Using the work of an expert*

In cases of asset valuation, assessment of asset impairment and determination of fair value of financial instrument, it is common for auditors to rely on the work of an expert. However, we noted that some practitioners merely obtained a copy of the expert's report as audit evidence without performing any other audit procedures on the expert's work.

HKSA 620 sets out guidance on using the work of an expert as audit evidence. Practitioners should evaluate the professional competence and objectivity of the expert and should ensure that the scope of the expert's work is adequate for the purposes of the audit e.g. review the terms of reference which are often set out in written instructions from the entity to the expert. More importantly, Practices should evaluate the appropriateness of the expert's work as audit evidence e.g. use of source data, assumptions and methods and consistency with prior periods and results of the expert's work in the light of the practitioner's overall knowledge of the business and of the results of other audit procedures. Practices should consider making inquiries regarding procedures undertaken by the expert to establish whether the source data is relevant and reliable. If necessary, they may review or test the data used by the expert. Although the practitioners may not have the same expertise and cannot always challenge the expert's assumptions and methods, they will still need to obtain an understanding of the assumptions and methods used and to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures. If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, practitioner may need to hold discussions with the entity and the expert, apply additional audit procedures, including possibly engaging another expert, or modify the auditor's report.

7. *Third party confirmations*

Practices are reminded that it is the auditors' responsibility to assess audit risk and appropriate responses including whether circularization is a required audit procedure. Instances were noted where circularization was not performed at client management request and there was no clear documentation on the reasons for accepting such a request. Alternative audit procedures should be applied and clearly documented if the auditor agrees to management's request.

In other cases, circularization was carried out but there was no proper follow up actions or alternative audit procedures for non-replies. Non-replies should be properly followed up, usually by sending out second reminders. Practices should perform alternative audit procedures where no response is received to provide audit evidence about the assertions that the confirmation request was intended to provide.

Also, we identified in some cases where confirmations were arranged by client's personnel. When performing confirmation procedures, Practices should maintain control over the process of sample selection, send out the confirmation requests themselves and replies must be sent directly to the auditors. If the replies are in the form of fax or other electronic means, the auditors should perform all reasonable steps to verify the identity of the sending party is the same as the one whom the request is sent. Replies in original form are considered more reliable audit evidence.

8. *Manufacturing engagements*

Practice reviewers identified that some Practices do not fully understand their clients' business operation and control environment, in particular the production process which is the most significant business operation of a manufacturing entity. As a result, certain significant audit risks specifically relating to manufacturing business were not identified or addressed. For example:

- The accounting and auditing implications arising from different types of manufacturing arrangements with factories, e.g. subcontracting and import processing, are not identified.
- Failure to recognize that valuation of work-in-progress and finished goods is a risk area and therefore adequate audit procedures are not designed and performed e.g. assessment of reasonableness of overhead absorption rate, audit tests on completeness and accuracy of financial information used in calculating the inventory values and etc.
- Some Practices do not perform adequate audit procedures to ascertain whether their clients' inventories are carried at the lower of cost and net realisable value.
- In some cases, Practices assess adequacy of inventories provision only through identifying damaged or obsolete inventories when attending their clients' stock takes. There is no consideration of clients' inventory provision policies for damaged and obsolete inventories and assessment of the appropriateness of the policies based on reliable operational or accounting information such as product life cycle and inventory aging.

9. *Management representations*

Instances were noted where practitioners over rely on management representations and do not obtain other, more persuasive, audit evidence. Practices should remember that representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. If management representations are judged to be the only appropriate audit evidence, the practitioner should make a clear record of why that is the case and why he is prepared to rely on that evidence in forming his opinion. However, when the management representations are contradicted by other audit evidence, Practices should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

Also, in some cases, representation letters had not been tailored to the client's situation or significant representations from management were not included in the written representation letter. Sometimes, practitioners had not obtained audit evidence of management's acknowledgment of their responsibilities for the financial statements or the summary of uncorrected financial statement misstatements was not included in or attached to the written representations. Oral representations should be confirmed by management in writing to reduce the possibility of misunderstandings between the auditor and management.

10. *Determination of materiality*

Practice reviewers noted that some practitioners did not determine materiality for their audit engagements. According to HKSA 320 *Audit Materiality*, auditors should consider materiality and its relationship with audit risk when conducting an audit. Auditors should also assess whether the aggregate of uncorrected misstatements that have been identified during the audit is material by reference to the materiality determined by the audit team. When an auditor concludes that misstatements may be material, he needs to consider reducing audit risk by extending audit procedures or requesting management to adjust the financial statements. Practitioners are reminded that in addition to the quantitative evaluation of uncorrected misstatements, the qualitative aspect, i.e, nature of the misstatements, should also be considered in a conclusion.

Some practitioners were unable to demonstrate how the materiality level would affect the nature, extent and timing of planned procedures and would be used in evaluating the effects of misstatements. We understand that the determination of materiality is a matter of professional judgment. However, Practices should document the thought process they have gone through in determining the materiality level.

11. *Audit evidence and related judgements*

Practice reviewers identified issues in relation to the adequacy of audit evidence on file to support certain significant balances and related audit judgements. An important element of our review process is the assessment of significant audit judgements. During the course of our review, we challenged a number of auditor judgements including those relating to going concern, impairment of goodwill and other intangible assets. Practices need to be more robust in their assessment of areas which requires significant audit judgements.

When there is a potential going concern issue, practitioners should request client management to prepare formal documentation to support the going concern assumption, including forecasts that cover a period of at least twelve months from the date of approval of financial statements. Files should evidence that the assumptions underlying the forecasts have been subject to appropriate scrutiny. For impairment of goodwill and other intangible assets, we would expect there to be audit evidence to support audit judgements, including challenges to the reasonableness of key assumptions such as the appropriateness of discount rate and future growth rates.

12. *Audit Documentation*

In our previous reports and forums, we have explained why we consider the quality of audit documentation is important. Many of the issues raised in our reviews relating to the clarity or sufficiency of audit documentation were initially raised in the context of apparent deficiencies in audit evidence. We therefore believe that Practices should continue to give a clear message to their partners and staff on the importance of good quality audit documentation and the need for ongoing improvement in this area.

13. *Regulated clients*

A large number of Practices have audit clients that have additional reporting responsibilities under specific regulations and laws. These clients are subject to scrutiny by their own regulators who will also have an interest in the quality of audit work. Accordingly we have put some emphasis on reviewing audits of regulated entities during the 2009 practice review programme. Various common issues on audits of regulated clients identified during the reviews are set out below:

a) *Audit of securities brokers*

A Financial Reporting and Auditing Alert was issued in December 2009 drawing attention to the following areas where auditors did not take into consideration the guidelines from PN 820 *The Audit of Licensed Corporations and Associated Entities of Intermediaries*:

- Terms of engagement and management representation
- Risk of Fraud
- Understanding the entity and its environment
- Compliance with laws and regulations
- Circularisation
- Subsequent events
- Materiality for financial returns and compliance reports

Practitioners should pay attention to the guidance and recommended procedures of PN 820 in future audits.

b) Audit of non-life insurer

- Regulatory requirements

  When expressing an audit opinion in relation to client's solvency margin requirement as at year end date as well as two other dates, a few practitioners failed to recognize the liabilities used as of two other dates should refer to the liabilities as at preceding financial year end date as set out in Section 25A of Insurance Companies Ordinance, not the unaudited liabilities as at two other dates.

- Provision for Claims Incurred But Not Reported ("IBNR")

  Instances were noted where there was limited documentation on the extent of audit work performed on IBNR e.g. calculation basis and sufficiency level of the provision.

Findings and educational points from professional standards monitoring programme

This section sets out an overview of more significant or topical issues noted from reviews of published financial statements. The issues are presented by topic with references being made to applicable financial reporting standards.

During the course of reviews, the QAD noted that there were common accounting issues that seemed to be related to or exacerbated by the global financial crisis. They are summarised in the first section below. Other specific topics such as application issues in accounting for business combinations, revenue recognition on multiple deliverables and agriculture accounting and disclosures are discussed in the second section.

In addition to this report, common observations noted in reviews are also communicated to members by means of Financial Reporting and Auditing Alerts and training sessions under TUE training sessions.

Section I – Global financial crisis - financial reporting issues

The global financial crisis has brought a lot of issues to financial reporting, such as decline in value of investments, liquidity concerns, increasing costs of funding and impairment of assets. This section summarises the common issues noted from our reviews. We believe they are useful to members for consideration in preparing or auditing financial statements in volatile markets.

1. Impairment of assets including goodwill

a) Indicators

Continuous negative operating cash flows and accounting losses could be strong indicators that assets may have been impaired. In many instances, despite the presence of the aforesaid indicators, the QAD noted that no impairment provisions were made and no disclosures provided to explain how management had carried out an impairment assessment of the need for impairment provisions.

Enquiries were often raised to auditors on how they were satisfied that no impairment provision was required. In general, responses received from auditors explained that the management has undertaken comprehensive impairment assessments and they were satisfied with the cash flow projections prepared by management.

Paragraph 132 of HKAS 36 *Impairment of Assets* states that *"An entity is encouraged to disclose assumptions used to determine the recoverable amount of assets (cash-generating units) during the period"*. In view of this, the QAD recommends members to disclose the impairment assessment including key assumptions used in calculating the recoverable amount of assets to assist readers' understanding of financial statements.

b) *Assessment of impairment*

In a few cases reviewed, there were indications that key assumptions (e.g. discount rate and growth rate) used in measuring value in use when carrying out impairment assessment of assets might not be appropriate.

Examples are as follows:

- discount rate and growth rate used were the same as previous year despite clear and often substantial changes in the economic situation faced by the company;
- substantially higher growth rates as compared to previous years in spite of continuous losses being incurred;
- no explanation of substantial decreases in discount rate as compared to previous year; and
- same discount rate and growth rate applied for different cash generating units.

Paragraph 55 of HKAS 36 states that *"The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of (a) the time value of money; and (b) the risks specific to the asset for which the future cash flow estimates have not been adjusted"*.

Paragraph 33(c) of HKAS 36 requires that *"... growth rate shall not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified"*.

The discount rate and growth rate are key assumptions in value in use calculations. A change in discount rate and growth rate used in cash flow projections may significantly increase or decrease the amount of impairment loss. Therefore the determination of discount rate and growth rate in value in use calculations is often a key audit risk area that the auditor needs to pay particular attention to.

Members are advised to refer to Appendix A in HKAS 36 which provides guidance on the use of present value techniques in measuring value in use.

The QAD also found some cases where significant impairment losses were recognised for goodwill and other intangible assets under the circumstance of continued loss making status of the entities. However, other assets such as property, plant and equipment, which were the entities' main assets generating cash flows, were not affected and no disclosures were made explaining why tangible assets were not affected by the circumstances causing significant impairment to intangibles.

The QAD would also like to remind members of the following disclosures relating to assessment of impairment that are required but often not found:

- Information about the estimates used to measure the recoverable amount of a cash-generating unit when goodwill or an intangible asset with an indefinite useful life is included in the carrying amount of that unit, as required by paragraph 134 of HKAS 36.
- Assumptions used in cash flow projections may be key sources of estimation uncertainty or involve critical accounting judgements and therefore should be disclosed. It will be helpful to readers of the financial statements if disclosures are made on management judgement in respect of the uncertainties and the key factors that have been considered during the impairment assessment based on the entity's own situation.
- Members are reminded to assess whether a reasonably possible change in a key assumption, which has been based on to determine the recoverable amount of a cash-generating unit, would cause the carrying amount to exceed its recoverable amount. If that is the case, members should ensure that the disclosures required by paragraph 134(f) of HKAS 36 are included in the financial statements.

In order to ensure adequacy of financial statements disclosures, members are recommended to refer to the disclosure requirements stated in paragraphs 126 to 137 of HKAS 36, especially paragraphs 130 and 134.

2. *Investment in available-for-sale financial assets*

As a result of the economic downturn, many entities experienced a decline in fair values of equity investments. However, in some cases we noted that the impairment assessment of equity investments performed by entities was not appropriate. In determining whether the equity investments are impaired, members are reminded to refer to HKAS 39 *Financial Instruments: Recognition and Measurement*.

An example encountered by the QAD showed that there was a very significant decline in fair value of available-for-sale investments below their original costs that was accounted for within changes in equity rather than profit or loss. In the response to our enquiry, the entity and auditor considered that the decline was a rare circumstance and a short-term fluctuation due to the financial downturn.

Paragraph 61 of HKAS 39 requires that *"A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment"*.

This requirement states explicitly that either significant "**or**" prolonged decline in the fair value of an investment is sufficient to require the recognition of impairment loss. Accordingly, if the decline in fair value of an available-for-sale investment is significantly below its cost, even if it is not prolonged, an impairment loss is required.

Members are advised to refer to the release of IFRIC Update in July 2009. IFRIC noted some applications in practice that are not in accordance with IAS 39. IFRIC emphasised that the standard cannot be read to require the decline in value to be both significant "**and**" prolonged. It also highlighted that the fact that the decline in the value of an investment is in line with the "overall level of decline in the relevant market" does not mean that an entity can conclude that impairment is not required. The IFRIC Update is available at:

http://www.iasb.org/NR/rdonlyres/2DED3CF2-147A-4830-A9AC-BDE2C0CA48BC/0/IFRIC0907.pdf

Another important point to note for available-for-sale financial assets is that according to paragraph 67 of HKAS 39, *"When a decline in the fair value of an available-for-sale financial asset has been recognised directly in equity and there is objective evidence that the asset is impaired (see paragraph 59), the cumulative loss that had been recognised directly in equity shall be removed from equity and recognised in profit or loss even though the financial asset has not been derecognised"*. Therefore, the debit balance of investment revaluation reserve that has been recorded prior to a decrease in fair value should be transferred to profit or loss as impairment loss, even though the entity had not disposed of the investments.

Replacement project of IAS 39

The International Accounting Standards Board ("IASB") issued IFRS 9 *Financial Instruments* in November 2009 on the classification and measurement of financial assets. In light of convergence with IFRS, HKICPA issued HKFRS 9 *Financial Instruments* in the same month. The standard is effective for annual periods beginning on or after 1 January 2013 and early application permitted.

Until an entity adopts HKFRS 9, the above discussion on impairment assessment of available-for-sale financial assets continues to be applicable.

The publication of IFRS 9 represents the completion of the first part of a three-part project to replace IAS 39 with a new standard IFRS 9. The standard applies to financial assets only and not financial liabilities. An exposure draft for financial liabilities classification and measurement is under development by IASB.

Members may refer to the following link for the press release issued by IASB on issuance of IFRS 9:http://www.iasb.org/News/IASB+

completes+first+phase+of+financial+instruments+accounting+reform.htm

3. *Going concern considerations*

In the period of global financial difficulties there were, not surprisingly, many indicators of material uncertainties (e.g. a net current liability position, continuous operating losses, excessive reliance on short-term borrowings and insufficient operating cash flows) that may cast significant doubt upon the entity's ability to continue as a going concern.

Enquiries were made with auditors on how they were satisfied that the financial statements were prepared on a going concern basis to support an unqualified audit opinion.

The QAD would like to draw members' attention that when there are material uncertainties that raise doubt on the entity's ability to operate as a going concern, those uncertainties are required to be disclosed in accordance with HKAS 1. For example, management assessment on its ability to obtain funds from financial institutions and generation of cash from future operations should be disclosed.

Members may also refer to HKSA 570 *Going Concern* for examples of events or conditions, which may give rise to business risks that individually or collectively may cast significant doubt about the going concern assumption.

4. *Financial risk management disclosures*

Users of financial statements are increasingly looking for more transparency in disclosures including, but not limited to, critical accounting judgements and key sources of estimation uncertainties, capital management, liquidity, concentration of credit risk and fair value measurement. The QAD would therefore urge members to take particular care with these financial risk management disclosures, when preparing or auditing financial statements.

The following paragraphs describe general disclosure issues noted by the QAD on financial risk management and suggest ways to enhance the quality of disclosures.

a) *Critical accounting estimates, assumptions and judgements*

HKAS 1 requires disclosure of judgements management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements. It also requires disclosure of key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

The QAD observed in many cases that, in addition to the examples quoted in point 1 above on impairment assessment, the disclosures of critical accounting estimates, assumptions and judgements in the following areas were often general and did not clearly explain how the management assessment was applied in respect of the following areas :

i. measurement of the fair values of the following:

- identifiable assets (e.g. intangibles) and liabilities on business combinations;
- financial instruments (e.g. convertible bonds), especially those which are not traded in an active market; and
- share options granted by the reporting entity under share-based payment transactions.

ii. determination of the useful lives of intangibles (e.g. know-how) acquired in a transaction. It is not clear whether the entity has taken into account the economic and legal factors which will influence the useful life of an intangible asset and how the uncertainties are addressed during the assessment; and

iii. management approach in determining the allowance on inventories and subsequent reversal.

Given that the situations of companies are different, disclosures made should provide users of the financial statements with information that is appropriate to the entity's circumstances.

b) *Capital risk management*

An entity may adjust its capital risk management policy in light of the changes in existing market conditions. With regard to common deficiencies noted in respect of capital risk management under HKAS 1, members are advised to refer to Financial Reporting and Auditing Alert No.6 in the following link: http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/financialauditing/2010/fraa-06.pdf

c) *Liquidity risk*

In most cases reviewed, maturity analysis for financial liabilities that shows the remaining contractual maturities was properly disclosed. However, other disclosures about the entities' liquidity risk exposure such as compliance with loan covenants and the implications of a breach, amount of unutilised banking facilities, and implications for the entity's operations if it is not able to obtain funding, were often not disclosed.

It is important that management should disclose risks that arise from financial liabilities and how they have been managed to provide users with a better understanding of the entity's liquidity position. For example, an entity's ability to meet debt covenant requirements and the implications of a breach of such covenants and what policies have been established to prevent a breach. In some instances where an entity has placed heavy reliance on short-term financing for its operations, management should disclose the entity's ability to raise funds, the sources of funds that are available and the implications for the entity if it failed to obtain funds.

Members should refer to Appendix B of HKFRS 7 *Financial Instruments: Disclosures* for additional application guidance.

d) Concentration of credit risk and information on credit quality of financial assets

HKFRS 7 requires the disclosure of concentrations of credit risk for financial instruments. Information such as activities that give rise to credit risk and the associated maximum exposure to credit risk, collateral held as security and its fair value, credit quality of financial assets that are neither past due nor impaired and an analysis of the age of financial assets that are past due but not impaired should be disclosed.

For full disclosure requirements of financial instruments, members are reminded to refer to the application guidance in Appendix B of HKFRS 7, which is an integral part of HKFRS 7.

From most of the cases reviewed, the QAD observed that entities are able to present information on the analysis of the age of financial assets that are past due but not impaired at the consolidation level. However, the disclosure for financial assets at the company level such as amounts due from subsidiaries was commonly overlooked.

The QAD also noted that on some occasions disclosure of objectives, policies and processes for managing credit risk and the methods used to mitigate credit risk appeared to have been based on locally available specimen financial statements and had not been tailored to address the specific circumstances of the reporting entity.

The following are examples of disclosures relating to credit risk of financial assets which are either inconsistent or too general:

- The information disclosed in the management discussion and analysis section of the annual report showed that the majority of sales were sourced from one customer. However the credit risk disclosure stated that there was no significant concentration of credit risk.
- It was disclosed that management believed trade receivables that were neither past due nor impaired were

with good credit quality or the entity only trade with recognised and credit worthy customers. However, such disclosures were too general as there was no quantitative or qualitative information to describe how management analyses the credit risk exposure arising from financial assets.

In order to fulfil the disclosure requirement of paragraph 36(c) of HKFRS 7 in respect of credit quality, members should refer to Implementation Guidance paragraph 23 of HKFRS 7 which provides some examples that an entity might use, i.e.

"(a) *an analysis of credit exposures using an external or internal credit grading system;*

(b) *the nature of the counterparty;*

(c) *historical information about counterparty default rates; and*

(d) *any other information used to assess credit quality*".

e) ***Fair value***

A number of enquiry and recommendation letters were issued by the QAD in respect of fair value disclosures required by HKFRS 7. The QAD would like to highlight a few frequently omitted disclosures for members' attention in preparing future financial statements:

- when a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities shall be disclosed;
- if changing one or more of those assumptions to reasonably possible alternative assumptions would change fair value significantly, the entity shall state this fact and disclose the effect of those changes; and
- for an investment in equity instruments that do not have a quoted market price in an active market, a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably is needed.

Section II – Other common or significant issues

1. *Accounting for business combinations*

HKFRS 3 *Business Combinations* specifies that all business combinations should be accounted for by applying the purchase method. We would like to remind members that three steps are involved in the purchase method as stated in paragraph 16 of HKFRS 3:

Step 1 – Identifying an acquirer

Step 2 – Measuring the cost of business combination

Step 3 – Allocating, at the acquisition date, the cost of the business combination to assets acquired (including goodwill) and liabilities and contingent liabilities assumed.

In 2009 reviews, most of the questions raised on application of HKFRS 3 were related to Step 2 and Step 3 above.

a) Measuring the cost of the business combination (Step 2)

As required by HKFRS 3, cost of business combination shall be determined at fair value at the date of exchange. It is a common practice in Hong Kong that consideration for acquisition is satisfied by issuance of shares by the purchasing company at a specified price stated in the sale and purchase agreements ("agreement price"). The QAD encountered some cases under this kind of arrangement where the purchasing company used the "agreement price" of its shares to account for the cost of business combination, rather than the published price of quoted shares at the date of exchange.

Explanations generally given were that the agreement price of shares, which was determined under an arm's length transaction between the buyer and seller, reflected the fair value of consideration. It was also argued that the prices of quoted shares may often have significant fluctuations after the companies announced the news of forthcoming acquisitions to the general public. Therefore they considered that the listed share prices might not have appropriately represented the fair value of the shares.

We would like to remind members that as required by paragraph 27 of HKFRS 3, the published price at the date of exchange of quoted shares provide the "best evidence" of fair value and shall be used except in rare circumstances. Therefore the QAD is of the view that short term fluctuations of share prices, which often happen in today's stock market, do not adequately support the condition of "rare" circumstance.

Paragraph 27 of HKFRS 3 also sets out that other evidence and valuation methods shall be considered only in the rare circumstance when the acquirer can demonstrate that the published price at the date of exchange is an unreliable indicator, which happens only when it has been affected by the thinness of market. The QAD therefore advises members of the need to carefully assess whether the quoted shares issued are affected by "thinness of market" before considering the use of other evidence or valuation method. In the cases reviewed, the QAD noted that the reply letters did not provide adequate explanation to support the existence of "thinness of market".

b) Allocating, at the acquisition date, the cost of the business combination to assets acquired and liabilities and contingent liabilities assumed (Step 3)

Among the cases reviewed, there was often a significant balance of goodwill recognised when subsidiaries were acquired. In one case, the goodwill recognised almost equaled cost of acquisition because the fair value of identifiable net assets of the subsidiaries acquired was minimal. However, there was no disclosure explaining the factors that contributed to the significance of the balance of goodwill.

In the context of HKFRS 3, the above observation prompted the following questions:

i. whether identifiable assets, liabilities and contingent liabilities that existed at the acquisition date have been all identified (i.e. identification issue); and

ii. whether the identifiable assets, liabilities and contingent liabilities have been properly measured at fair value on acquisition (i.e. fair value measurement issue).

The application issues on "identification" and "fair value measurement" in accounting for business combinations are discussed below:

Identification issue

In some cases, auditors explained that assets and liabilities acquired in the business combinations were identified based on review of the financial statements of the acquirees.

Reviewing the financial statements of the acquirees may not be sufficient to identifying all the assets and liabilities that existed at the acquisition date. According to paragraph 44 of HKFRS 3, identifiable assets and liabilities acquired in a business combination may include assets and liabilities not previously recognised in the acquiree's financial statements because they are not qualified for recognition before acquisition. Therefore additional work may be required to ensure all assets and liabilities are recognised.

Our reviews also questioned whether sufficient consideration had been given to identifying intangible assets that existed on the acquisition date. The concern is that the significant balance of goodwill may have included intangible assets which needed to be separately recognised. Examples encountered by the QAD where intangible assets may not have been properly identified and recognised separately from goodwill are:

- in-process research and development (e.g. drugs under development for pharmaceutical companies); and
- exclusive rights granted by a government authority at nil cost for engaging in a new type of service in the market.

Items acquired in a business combination that meet the definition of an intangible asset are required to be separately recognised from goodwill provided that their fair value can be measured reliably and the entity has control over them.

The QAD recommends members to read through the Illustrative Examples section of HKFRS 3. Although the examples are not exhaustive, they can help members have more understanding of what items acquired in a business combination meet the definition of an intangible asset and should be recognised separately from goodwill.

Fair value measurement issue

In our reviews, the application issues noted on fair value measurement of net assets acquired in a business combination were also mainly related to intangibles.

Some auditors' replies explained that although the intangibles were identified, their fair values were not fairly measurable due to uncertainty in future market prospects. Examples of intangibles that we encountered are mining rights, timber concession rights, in-process research and development projects of pharmaceutical products and exclusive rights granted by government which were acquired in the business combinations.

The above explanation may not have sufficient regard to the requirements of the following standards:

- As stated in paragraph 35 of HKAS 38 *Intangible Assets*, fair value of intangibles acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill. For estimates used to measure an intangible asset's fair value, there may be a range of possible outcomes with different probabilities. In this case, the uncertainty is taken into account in the measurement of the asset's fair value, rather than demonstrating an inability to measure fair value reliably.

  Therefore "uncertainty" of future business prospects is not a reason for precluding an entity from performing fair value measurement of intangibles acquired in business combinations. Instead, the relevant factors of uncertainties should be taken into account in the determination of fair value.

- Paragraph 35 of HKAS 38 further specifies that if an intangible asset acquired in a business combination has a finite useful life, there is a "rebuttable presumption" that its fair value can be measured reliably. The only circumstances in which the presumption may be rebutted are whether an asset arises from legal or other contractual rights and either (i) is not separable; or (ii) is separable but there is no history or other evidence of exchange transactions for the same or similar assets that otherwise estimating fair value would be dependent on immeasurable variables (paragraph 38 of HKAS 38).

It was often noted that intangibles acquired in business combinations had finite useful lives and also did not meet the conditions stated in paragraph 38 of HKAS 38. Therefore the presumption in paragraph 35 of HKAS 38 is not rebutted and fair value should be reliably measurable.

- The QAD often noted that intangibles were the main assets acquired in the acquisition and therefore it was reasonable to expect that future cash flows would be substantially generated from the intangibles and that the fair values could be estimated based on cash flow projections. The QAD also noted that the purchasing companies were able to perform impairment testing for goodwill at the balance sheet date based on value in use calculations using cash flow projections. Therefore it appears not to be reasonable that the purchasing companies were unable to derive the fair values of intangibles acquired in business combinations by use of discounted cash flow method or other valuation techniques at the time of acquisitions.

  The QAD would like to remind members that assets (i.e. goodwill or intangibles) after initial recognition are accounted for differently and therefore it is not acceptable to take the view that recognition of intangibles separately from goodwill is only a reclassification matter in the balance sheet.

  Acquisition of business or assets

  We would like to remind members that it is an important to determine whether the transaction is an acquisition of business which has to be accounted for under HKFRS 3 or an acquisition of a group of assets where HKFRS 3 does not apply. For the cases reviewed, members were generally able to explain how they assessed the transactions in the context of HKFRS 3.

2. *Share options*

Two issues of more significance noted in relation to accounting for share options are set out below.

a) *Cancellation of share options granted*

In some instances, we noted share options that were granted by listed companies were cancelled during the vesting period. However, there was no accounting policy disclosed to explain how the cancelled share options were accounted for and the reasons for the cancellation.

Members are reminded that cancellation of share options granted (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied) is addressed by paragraph 28 of HKFRS 2 *Share-based Payment*. It requires that an entity should account for a cancellation as an acceleration of vesting and recognise immediately share-based payment expense that otherwise would have been recognised over the remainder of the vesting period.

b) ***Share options granted to consultants***

In some instances, share options were granted by companies to "advisors" and "consultants". It was noted that fair values of share options granted to "advisors" and "consultants" were measured by reference to fair value of shares of the company which were the same measurement as used for share options granted to "employees". However, there was no information in the financial statements to indicate whether the "advisors" and "consultants" are considered as "employees and others providing similar services" under the context of HKFRS 2 such that the measurement of the fair value of share options to employees is also applicable to share options granted to advisors and consultants.

Appendix A to HKFRS 2 provides the definition of "employees and others providing similar services".

Should the advisors and consultants are not "employees and other providing similar services", i.e. non-employees, we would like to remind members that the measurement of fair value of share options granted to employees and non-employees may be different.

Paragraph 10 of HKFRS 2 states that *"For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted"*.

Equity-settled grants to "employees" generally are measured at the fair value of equity instruments granted at the grant date because typically it is not possible to estimate reliably the fair value of services received from employees (HKFRS 2.11 & 12).

However, with regard to equity-settled grants to parties other than employees (e.g. advisors or consultants) there shall be a "rebuttable presumption" that the fair value of goods or services received can be estimated reliably. That fair value shall be measured at the date the entity obtains the goods or the counterparty renders the service (HKFRS 2.13). Therefore it is not appropriate to measure fair value of share options granted to non-employees by reference to fair value of listed shares apart from rare cases where the entity is able to demonstrate it was unable to reliably estimate the fair value of goods and services received.

3. *Impairment assessment on single company balance sheet*

It is common in Hong Kong that the reporting entities are incorporated outside Hong Kong having investments in subsidiaries. The reporting entities often disclose the company level balance sheet as an explanatory note in the financial statements.

During our reviews, in one extreme case that no impairment assessment was carried out by the reporting entity on investments in subsidiaries despite the presence of impairment indicators. The auditor explained that the company was incorporated outside Hong Kong and therefore the audit opinion did not extend to the investments in subsidiaries which had been fully eliminated at the consolidation level.

The QAD did not accept the above explanation. The company balance sheet has been disclosed as an explanatory note in the consolidated financial statements and therefore it is reasonable for a reader to expect that the company balance sheet note is audited. Should the company balance sheet note be regarded as unaudited information, the auditor has failed to comply with HKSA 700 by not excluding the note from the scope of audit opinion. Therefore the QAD would like to remind members that if the balance sheet of the holding company is disclosed as part of the consolidated financial statements, sufficient audit work on impairment assessment is performed on the investments costs in subsidiaries if there are indications for impairment.

4. *Agriculture accounting and disclosures*

HKAS 41 *Agriculture* prescribes the accounting treatment, financial statement presentation, and disclosures related to agricultural activity.

As many members may not be familiar with the application of HKAS 41, we believe that it is a good chance to raise some issues noted from our reviews to help members have more understanding of HKAS 41.

We noted companies that apply agricultural accounting were mainly engaged in plantation of forest for timbering, cultivation of vegetables and fruit trees and raising of livestock in countries outside Hong Kong. No recognition and measurement issues were identified during the course of reviews. The deficiencies noted are disclosure matters.

Fair value measurement is applied in accounting for biological assets and agricultural produce under HKAS 41. We noted in our reviews that fair value disclosures are general or limited and that the quality can be improved by providing more specific explanations in the financial statements.

For example, although companies have disclosed that fair values were determined by independent professional valuations, the description of the significant assumptions used in determining the fair values of biological assets are rather general as there is no specific information on the significant assumptions applied, e.g. what recovery rates were used in the fair value calculations, location of the forest area and species of lumber.

Other disclosures required by paragraphs 40, 46, 47 and 49 of HKAS 41 were also missed, such as aggregate gains and losses arising from initial recognition and changes during the year, non-financial measures or estimates of the physical quantities, methods and significant assumptions applied in determining the fair value and the Group's risk management strategies related to agricultural activity.

5. *Withholding tax on dividend distribution of subsidiaries in Mainland China*

From 2008 under the relevant new tax rule of Mainland China, foreign investors of foreign investment enterprise in Mainland China ("FIE") were subject to a withholding tax on dividends distributed by FIE from the FIE's profits.

Given that it is usual that Hong Kong listed companies have major operations in Mainland China, it is reasonable to expect that some of the listed companies in Hong Kong are affected by this new tax law in Mainland China. The implication is that deferred tax liability shall be recognised as undistributed profits of subsidiaries in Mainland China constitute taxable temporary differences, unless the conditions set out in paragraph 39 of HKAS 12 *Income Taxes* are met. The amount of unrecognised temporary difference shall be disclosed as required by paragraph 81(f) of HKAS 12 when deferred tax liability is not recognised.

In some reviews, we noted that companies have subsidiaries in Mainland China which reported profits in 2008 as indicated in geographical segment information note. However, there was no mention in the financial statements of the assessment of tax impact due to the implementation of the new tax rule on withholding tax.

The QAD reminds members to carefully assess the financial implication of the implementation of withholding tax rule and to disclose the relevant information in the financial statements as explained above.

6. *Revenue recognition for multiple deliverables in a single transaction*

There are cases under review where there is more than one deliverable involved in a sale transaction. The QAD considers that such transactions may be regarded as a multiple element arrangement. For example, a provision of IT contract services may include several elements: design, development and installation of tailor-made software, sale of related hardware and other software and provision of after-sale maintenance services.

Members are reminded to give consideration to the requirements of paragraph 13 of HKAS 18 *Revenue*. By applying the principle in paragraph 13 of HKAS 18, revenue should be allocated to each component in order to reflect the substance of the transaction. For example, in the above fact pattern, it may be appropriate to split the transaction into several elements, allocate the sale consideration and then apply revenue recognition criteria to each element separately.

The QAD is of the view that it is important to assess whether a separable element (e.g. after-sale services) is material to the single transaction. If it is material, that identifiable element should be separately accounted for in the financial statements to comply with paragraph 13 of HKAS 18. In relation to multiple element arrangements, further guidance can be found in the appendix to HKAS 18 and HK(IFRIC) 13 *Customer Loyalty Programmes*, HK(IFRIC) 15 *Agreements for the Constructions of Real Estate* and HK(IFRIC) 18 *Transfers of Assets from Customers*. Members should carefully assess the substance of the transaction and apply the relevant standards accordingly.

7. *Revenue accounting policy*

We continue to identify instances where companies have not tailored the accounting policy for revenue recognition disclosed in the financial statements. The accounting policies are often "boilerplate" by reference to specimen financial statements published by larger accounting firms which are too general without clearly addressing the situation of the reporting entities.

For example, in one case that a company disclosed a single revenue accounting policy with no information attributable to different business activity was carried out carried out by the reporting entity. Through exchange of correspondence with auditors, we further understood that revenue accounting policy note had covered revenue generated from different nature of businesses associated with different kinds of risks and rewards.

The QAD considers that the accounting policy note for revenue recognition is an important disclosure which enables users to understand how the entity recognises revenue generated from business operations.

To enhance the quality of disclosure, the QAD is of the view that the disclosure of revenue accounting policy should contain sufficient information explaining the recognition criteria and identification of circumstances in which those criteria will be met with appropriate level of details linked to the entity's business operations.

March 2010

Members of the Standards & Quality Accountability Board in 2009

Name	Position	Company
Mr. CHOW Man-yiu, Paul	Chairman	Hong Kong Exchanges and Clearing Limited
Mr. BEST Roger Thomas	Member	Deloitte Touche Tohmatsu
Miss. CHAN Mei Bo, Mabel	Member	Mabel Chan & Co.
Ms. CHIU Lai Kuen, Susanna	Member	Li & Fung (Trading) Ltd.
Mr. CHONG Kim	Member	Hong Kong Monetary Authority
Mr. CHOW Siu Lui, Jack	Member	KPMG
Mr. LI Kwok Tso	Member	The Treasury, Government of HKSAR
Mr. MAR Selwyn	Member	Nexia Charles Mar Fan & Co.
Ms. SHIH Edith	Member	Hutchison Whampoa Limited
Mr. WONG Ying-tao, Peter	Member	Audit Commission, HKSAR

Members of the Practice Review Committee in 2009

Name	Position	Company
Mr. FUNG Ying Wai, Wilson	Chairman	Jardine Matheson Limited
Mr. CHAN Kam Wing, Clement	Member	BDO Limited
Mr. CROWE William Andrew	Deputy Chairman	KPMG
Ms. CHEUNG Yuk Ting, Mabel	Member	PricewaterhouseCoopers
Ms. FUNG Yee, Pammy	Member	Crowe Horwath (HK) CPA Limited
Mr. GEORGE, Richard John Weir	Member	Deloitte Touche Tohmatsu
Ms. KWOK Yuen Man, Eunice	Member	Mazars CPA Limited
Mr. LEONG Jonathan Russell	Member	Grant Thornton
Mr. MOK Yun Lee, Paul	Member	Orient Overseas (International) Ltd.
Mr. TAM King Ching, Kenny	Member	Kenny Tam & Co.

Members of the Professional Standards Monitoring Expert Panel in 2009

Name	Company
Mr. CHAN, Tak Shing	BDO Limited
Mr. CHENG, Chung Ching, Raymond	HLB Hodgson Impey Cheng
Ms. CHEUNG, Sau Ying, Olivia	Hong Kong Exchanges and Clearing Limited
Mr. CHOW, Siu Lui, Jack	KPMG
Mr. DING, Wai Chuen, Raphael	Guoco Group
Mr. FARRAR, Ian Peter	PricewaterhouseCoopers
Mr. HO, Che Kong, John	Leighton Asia Limited
Mr. MOK, Yun Lee, Paul	Orient Overseas (International) Ltd.
Mr. POGSON, Timothy Keith	Ernst & Young
Mr. TAYLOR, Stephen	Deloitte Touche Tohmatsu
Mr. YAN, Yiu Kwong, Eddy	Crowe Horwath (HK) CPA Limited

Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East, Wanchai, Hong Kong
Tel: (852) 2287 7228
Fax: (852) 2865 6603
Email: hkicpa@hkicpa.org.hk
Website: www.hkicpa.org.hk