A) Audit Report

A1) Auditor's Report – Unmodified Report (HKSA 700) and Modified Report (HKSA 705)

Nature of Issue	**Material**	**Pervasive**
Disagreement	Qualified with "except for"	Adverse Opinion
Limitation on scope	Qualified with "except for"	Disclaimer of Opinion
A matter that is presented or disclosed in the financial statements that it is fundamental to users' understanding of the financial statements	Unmodified opinion with an Emphasis of Matter Paragraph	In rare cases when there are multiple uncertainties the auditors may issue a Disclaimer of Opinion
A matter other than those that are presented or disclosed in the financial statements that, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report	Unmodified opinion with an Other Matter Paragraph	

A2) Identify and Discuss the Most Appropriate Form of Opinion

Under HKSA 700 the auditor is required to form an opinion on the client's financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and to express clearly that opinion through a written report that also describes the basis for that opinion.

HKSA 700 also states that an auditor may give an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Under HKSA 705, the auditor may conclude that a modification to his opinion on the client's financial statements is necessary.

There are three types of modified opinions, namely, a qualified opinion, an adverse opinion, and a disclaimer of opinion. The choice depends upon:

- The nature of the matter giving rise to the modification, that is, whether the financial statements are materially misstated or, in the case of an inability to obtain sufficient appropriate audit evidence, may be materially misstated; and

- The auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

The auditor should modify the opinion in the audit report when:

- he concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

- he is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

<u>Example from HKSA 700 – Unmodified Audit Opinion</u>

INDEPENDENT AUDITOR'S REPORT
TO THE SHAREHOLDERS OF ABC LIMITED
(incorporated in Hong Kong with limited liability)

Report on the Financial Statements

We have audited the financial statements of ABC Limited set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' Responsibility for the Financial Statements
The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X1, and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Source: HKICPA Learning Pack Chapter 17

Basic elements of audit report	Explanation
Title	The title should indicate that the report is by an independent auditor to confirm all the relevant ethical standards regarding independence have been met. This helps readers to identify the auditor's report and to easily distinguish it from reports that might be issued by others.
Addressee	The auditor's report should be addressed as required by the circumstances of the engagement, but is likely to be the shareholders or board of directors.
Introductory paragraph	This should identify the entity being audited, state that the financial statements have been audited, identify the financial statements being audited, specify the date and period covered by the financial statements and refer to the summary of significant accounting policies and other explanatory information.
Statement of directors' responsibility	There must be a heading "Directors" [or other appropriate term] responsibility for the financial statements'. The report must contain a statement that directors are responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework, and for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement whether due to fraud or error.

Basic elements of audit report	Explanation
Statement of auditor's responsibility	The auditor's report shall include a section with the heading "Auditor's responsibility". The report must state that the auditor is responsible for expressing an opinion on the financial statements. The report should explain that the auditor adhered to HKSAs and ethical requirements (ie the *Code of Ethics*) and that the auditor planned and performed the audit so as to obtain reasonable assurance that the financial statements are free from material misstatements. The report should describe the audit as including: • Performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements • The exercise of the auditor's judgment of risks of material misstatements whether due to fraud and how that assessment is made • Consideration of internal control relevant to the entity's preparation and fair presentation of the financial statements but not expressing an opinion on the effectiveness of the entity's internal control • The evaluation of the appropriateness of the accounting policies used, the reasonableness of estimates and the overall presentation of information in the financial statements • The auditor's beliefs on whether the auditor has obtained sufficient and appropriate audit evidence to provide a basis for the auditor's opinion
Opinion paragraph	The auditor's report shall include a section with the heading "Opinion". If the auditor concludes that the financial statements give a true and fair view, he should express an unmodified opinion which states that the financial statements give a true and fair view or present fairly, in all material respects, in accordance with the applicable financial reporting framework.
Other reporting responsibilities	If the auditor is required by law to report on any other matters, this should be done in an additional paragraph below the opinion paragraph. The paragraph should be stated as "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section.
Date of the report	The report must be dated. This informs the reader that the auditor has considered the effect on the financial statements and on his report of events or transactions about which he became aware that occurred up to that date. The date should not be earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.
Auditor's address	The location where the auditor practises must be included. This is usually the city where the auditor has his office.
Auditor's signature	The report must contain the auditor's signature, whether this is the auditor's own name or the audit firm's name.

A3) Sample Audit Reports

Example from HKSA 705 – Qualified with Except For due to Disagreement

Basis for Qualified Opinion

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

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X1, and of its profits and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Example from HKSA 705 – Adverse Opinion

Basis for Adverse Opinion

As explained in Note X, the Company has not consolidated the financial statements of subsidiary DEF Limited it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under Hong Kong Financial Reporting Standards, the subsidiary should have been consolidated because it is controlled by the Company. Had DEF been consolidated, many elements in the financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 20X1, and of the Group's [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards. In all other respects, in our opinion the consolidated financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Example from HKSA 705 – Qualified with Except For due to Limitation on Scope

Basis for Qualified Opinion

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

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X1, and of its profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Example from HKSA 705 – Disclaimer of Opinion

Report on the Financial Statements

We were engaged to audit the financial statements of ABC Limited set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. Except for the inability to obtain sufficient appropriate audit evidence as explained below, we conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

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

Disclaimer of Opinion

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

HKSA 706 Emphasis of Matter Paragraph and Other Matter Paragraph

Per HKSA 706, if the auditor considers it necessary to draw users' attention to a matter that are presented or disclosed in the financial statements that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report.

Per HKSA 706, if the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, the auditor shall do so in an Other Matter paragraph in the auditor's report.

Example from HKSA 706 – Emphasis of Matter Paragraph

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the uncertainty related to the outcome of the lawsuit filed against the Company by DEF Company. Our opinion is not qualified in respect of this matter.

Example – Other Matter Paragraph

Other Matter

The financial statements of the Company for the year ended 31 December 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on 31 March 20X1.

Circumstances in which an other matter paragraph may be necessary:

(a) When the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive, the auditor may consider including an other matter paragraph in the auditor's report to explain the fact.

(b) The auditor can elaborate matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon under law, regulation or generally accepted practice in a jurisdiction.

(c) An entity may engage the auditor to report on both sets of financial statements under two general purpose frameworks (ie Hong Kong Financial Reporting Standards and the International Financial Reporting Standards).

The auditor may include an other matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.

(d) When the auditor's report is intended for specific users, the auditor may consider it necessary to include an other matter paragraph, stating that the auditor's report is intended solely for the intended users, and should not be distributed to or used by other parties.

<u>A4) The new Hong Kong Companies Ordinance Offences relating to contents of auditor's reports</u>

Source: HKICPA Learning Pack Chapter 17

The new Companies Ordinance ("the new CO") introduces a **new offence** relating to **omissions in an auditor's report** under s. 408.

If the auditor is of the opinion that the financial statements of a company are not in agreement with its accounting records in any material respect,

or

the auditor has **failed to obtain all the information or explanations** that are necessary and material for the purpose of the audit ("the specified statements"),

the auditor must state that fact in the auditor's report pursuant to s. 407 of the new CO.

Under the new CO, an auditor who knowingly or recklessly causes any of the specified statementsto be omitted from an auditor's report commits an offence under s. 408 and is liable to a fine notexceeding $150,000.

The offence in s. 408 will safeguard the reliability and integrity of auditor's reports and enhance enforcement.

E1) Who may be held liable for the offences under s. 408(1) of the new Companies Ordinance?

Any of the persons specified below commits the offence if the person knowingly or recklessly causes any of the specified statements to be omitted from an auditor's report:

- If the auditor is a natural person, the auditor and every employee and agent of the auditor who is eligible for appointment as auditor of the company;
- If the auditor is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company;
- If the auditor is a body corporate, every officer, member, employee and agent of the auditor who is eligible for appointment as auditor of the company.

B) HKSA 570 Going Concern

B1) The Going Concern Assumption

Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future.

Financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.

When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

HKAS 1 requires management to make an assessment of an entity's ability to continue as a going concern.

B2) Responsibilities of the Auditor

The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

However, as described in HKSA 200, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern.

The auditor cannot predict such future events or conditions.

Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

B3) Objectives of the auditor

The objectives of the auditor are:

(a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;

(b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

(c) To determine the implications for the auditor's report.

B4) Risk Assessment Procedures and Related Activities

When performing risk assessment procedures as required by HKSA 315, the auditor shall consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

In so doing, the auditor shall determine whether management has already performed a preliminary assessment of the entity's ability to continue as a going concern, and:

(a) If such an assessment has been performed, the auditor shall discuss the assessment with management and determine whether management has identified events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, if so, management's plans to address them;

(b) If such an assessment has not yet been performed, the auditor shall discuss with management the basis for the intended use of the going concern assumption, and inquire of management whether events or conditions exist that may cast significant doubt on the entity's ability to continue as a going concern.

The auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

B4.1) Events or Conditions That May Cast Doubt about Going Concern Assumption

The following are examples of events or conditions that may cast significant doubt about the going concern assumption.

This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

A4.2) Mitigating factors

The significance of such events or conditions often can be mitigated by other factors.

For example, the company can obtain more cash by

- by disposing of assets
- rescheduling loan repayments
- obtaining additional capital through issue of shares

B5) Evaluating Management's Assessment

The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.

In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework.

If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements, the auditor shall request management to extend its assessment period to at least twelve months from that date.

In evaluating management's assessment, the auditor shall consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.

B6) Period beyond Management's Assessment

The auditor shall inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.

B7) Additional Audit Procedures When Events or Conditions Are Identified

If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors.

These procedures shall include:

(a) Where management has not yet performed an assessment of the entity's ability to continue as a going concern, requesting management to make its assessment.

(b) Evaluating management's plans for future actions in relation to its going concern assessment, whether the outcome of these plans is likely to improve the situation and whether management's plans are feasible in the circumstances.

(c) Where the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action:

(i) Evaluating the reliability of the underlying data generated to prepare the forecast; and

(ii) Determining whether there is adequate support for the assumptions underlying the forecast.

(d) Considering whether any additional facts or information have become available since the date on which management made its assessment.

(e) Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

Audit procedures may include the following:

- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reading the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

Exam tips!!!

In the exam you are usually required to identify risks that an entity may not be a going concern and then provide audit procedures to address these risks.

It is important that the audit procedures are specific to the case and not generic procedures copied out of the learning pack!

B8) Audit report: Use of going concern appropriate but a material uncertainty exists

If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and

(b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph.

If adequate disclosure is not made in the financial statements, the auditor shall express a qualified opinion in accordance with HKSA 705.

Source: HKICPA Learning Pack Chapter 16

B8.1) Material uncertainty with adequate disclosures

If adequate disclosures are made in the financial statements of the following:

- Principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern
- Management's plans to deal with these events or conditions
- That a material uncertainty exists ("material uncertainty" is used in HKAS 1 (Revised) in discussing the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements).
- The entity may be unable to realise its assets and discharge its liabilities in the normal course of business

the auditor shall express an **unmodified opinion and include an emphasis of matter paragraph** in the auditor's report to:

(a) highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

(b) draw attention to the note in the financial statements that discloses the matter.

Emphasis of matter

Without qualifying our opinion, we draw attention to Note 5 in the financial statements which indicates that the Company incurred a net loss of HK$10,000,000 during the year ended 31 December 20X0 and, as of that date, the Company's current liabilities exceeded its total assets by HK$15,000,000. These conditions, along with other matters as set forth in Note 3, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern.

B8.2) Material uncertainty with inadequate disclosures

If the auditor concludes that the use of the going concern assumption is appropriate but a material uncertainty exists and there is inadequate disclosure in the financial statements, the auditor shall express a qualified opinion or adverse opinion in accordance with HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report.*

Basis for qualified opinion

The Company's financing arrangements expire and amounts outstanding are payable on 19 March 20X1. The Company has been unable to re-negotiate or obtain replacement financing. This situation indicates the existence of a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Qualified opinion

In our opinion, except for the incomplete disclosure of the information referred to in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X0 and of its financial performance and its cash flows for the year then ended in accordance with…

B8.3) Inappropriate use of going concern assumption

If the financial statements have been prepared on a going concern basis, but in the auditor's judgment this is **inappropriate**, the auditor must express **an adverse opinion**. This applies regardless of whether the financial statements include disclosure of the inappropriateness of management's use of the going concern assumption.

Basis for adverse opinion

The Company's financing arrangements expired and amounts outstanding are payable on 31 December 20X0. The Company has been unable to re-negotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not fully disclose this fact.

Adverse opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view of the financial position of the Company as at 31 December 20X0, and of its financial performance and its cash flows for the year then ended in accordance with …

Summary

Source: HKICPA Learning Pack Chapter 16

Scenario	Impact on auditor's report
Going concern assumption appropriate but material uncertainty which is adequately described and disclosed	Unmodified opinion and emphasis of matter paragraph
Going concern assumption appropriate but material uncertainty which is not adequately disclosed	Qualified or adverse opinion
Use of going concern assumption inappropriate	Adverse opinion
Management unwilling to make or extend its assessment	Qualified or disclaimer of opinion

Q1) HKICPA QP Mod C Past Paper - JUN 2012

X Limited operates a local chain of five retail shops in Hong Kong mainly selling a particular brand of household electric appliances, known as Brand A. Brand A is manufactured and supplied by A Multinational Corporation ("A Corp") based in Japan.

X Limited has an exclusive distribution agreement with A Corp to sell and distribute Brand A products in Hong Kong. The current agreement will end on 31 March 2011, and A Corp has already expressed the intention to set up its own distribution network in Hong Kong.

As part of the sales tactics, X Limited provides a two-year comprehensive warranty to customers at its own cost for all Brand A products. A provision covering the anticipated costs to be incurred by X Limited to honour the warranty has been booked in the financial statements.

Required:

In the context of the above case particulars, and from the prospective of the auditor of X Limited, discuss the main issues which could cast doubt about the going-concern of X Limited for the year ended 31 December 2010.

(9 marks)

ANSWER 1

Under HKSA 570 (Clarified) *Going Concern*, X Limited's auditor shall obtain sufficient appropriate audit evidence about the appropriateness of X Limited management's use of the going concern assumption in the preparation of the financial statements and conclude whether there is a material uncertainty about X Limited's ability to continue as a going concern.

Accordingly, the auditor shall consider the going concern uncertainty affecting X Limited which includes the following main issues.

Loss of the distribution rights for Brand A

As the distribution agreement with A Corp will expire on 31 March 2011, X Limited may soon lose its distribution rights to sell its main brand of household electric appliances in Hong Kong.

Without Brand A products, the shops of X Limited may not be able to operate or survive.

Uncertainty about the sales and profits of new products (if any)

X Limited should search for new products to maintain the availability of a good product range in its shops after the loss of its distribution rights for Brand A. There is uncertainty in respect of X Limited's ability to secure new products.

Even if new products are put on the shelves, there is uncertainty whether those new products can sell and produce profits for X Limited.

Provision for the costs to be incurred under the warranty

The costs to be incurred under the two-year warranty are supposed to be covered by the provision.

However, the amount of provision is likely based on a management forecast, and there is uncertainty in respect of the reliability of such a forecast and its assumptions.

The degree of uncertainty will be particularly high when X Limited no longer sells Brand A products and is likely to lose any technical support currently received from A Corp.

Rental commitment

As X Limited has five retail shops in Hong Kong, there is uncertainty in respect of the remaining terms of X Limited's rental commitment on these retail shops.

If the rental commitment goes beyond 31 March 2011, the flexibility of X Limited to adopt a new business model and to sell new products (or even its survival) would be threatened.

Q2) HKICPA QP Mod C Past Paper – SEP 2006

General Newspaper Limited ("GN") is a long established local Chinese newspaper publisher with a well known brand name. However, GN's market share is small since GN takes a traditional editorial stance that is not attractive to the general public nowadays. The newspaper market in Hong Kong is also becoming intensely competitive: free news dissimilation is available in the internet and more newspapers relying purely on advertisement income are distributed free to readers. In this environment, GN reported a loss for the first time in its history in 2004, although the amounts of losses were not significant. GN has always been conservative in its financial management, financing most of its non-current assets by equity. However, GN is relying increasingly on bank overdrafts to finance its daily operations and its settlement of trade liabilities has slowed. As at 31 December 2005, GN reported a net current liability of HK$2,000,000, which represented approximately 1% of GN's capital and reserves.

For the year ended 31 December 2005, KTT & Co is the auditor of GN's financial statements which were to be issued by the directors of GN early the following week (on 3 May 2006). KTT & Co has performed all the audit work and procedures necessary to comply with the auditing standards.

KTT & Co considered the draft financial statements to be true and fair and prepared to issue an unqualified report after the financial statements were issued by the directors.

However, the engagement partner of KTT & Co heard on the television news that 25 of GN's 200 staff had gone on strike, accusing GN of delaying salary payments for 2 months. The 25 staff threatened to apply to the court to liquidate GN if they had not been fully paid by mid May, and 10 of the 25 staff would resign immediately after the strike.

Required:

Determine the appropriate actions that KTT & Co should take in accordance with the relevant auditing standards in response to these circumstances.

(13 marks)

ANSWER 2

The strike is a subsequent event under HKSA 560 since it is an event occurring after the balance sheet date. In particular, it is "an event occurring up to the date of the auditor's report" since it occurred before the date of the auditor's report.

In accordance with HKSA 560, KTT & Co should consider the effect of the strike on the financial statements and on the auditor's report.

Since KTT & Co has performed all the audit works and procedures that are necessary to comply with the auditing standards, KTT & Co should have already performed the typical audit procedures for events occurring up to the date of the auditor's report.

The strike may however raise concern as to whether the procedures performed by KTT & Co during the audit process were adequate and, if not, what further procedures are required.

In response to the payment delay and labour strike, KTT & Co should perform the following procedures:

1) Confirm with the management that GN has actually delayed salary payments to the 25 staff and enquire of the management the reasons for the delay.

2) Enquire of the management whether there have been other cases of salary delay besides these.

3) Enquire of the management whether GN would settle the outstanding amount before issuing the financial statements, and inspect documentary evidence for any settlement of the amounts due.

4) Re-consider the risk assessments made during the audit process to determine whether they remain valid.

   If the previous risk assessments are no longer valid, e.g. the integrity of the management is questionable since they deliberately concealed the facts about the delay in salary payment when KTT & Co performed the typical procedures on subsequent events, KTT & Co may need to revise the risk assessment and consider the effect on the audit procedures and the auditor's report.

5) Re-consider the management's assessment about GN's ability to operate as a going concern. This includes the following:

(1) Consider whether GN is able to settle the amount due and how GN will finance the settlement;

(2) Find out whether the strike and staff resignations would affect GN's daily operations;

(3) Review the management plan to prevent similar liquidity and labour issues from occurring;

(4) Obtain sufficient evidence to confirm or dispel the view that a material uncertainty about GN's going concern exists, e.g. new funding from shareholders or extension of bank credit;

(5) Consider any other mitigating factors;

(6) Obtain confirmation of the management's plan.

6) Consider the effect of the salary payment delay and labour strike after the year end on the auditor's report.

This includes determining (1) whether the facts should be disclosed in the financial statements and whether the disclosure is adequate in drawing financial statement users' attention to material uncertainty; (2) whether the report should be modified by adding an emphasis of matter paragraph, or other forms of modification as appropriate.

Q3) HKICPA QP Mod C Past Paper – SEP 2008

Good Prospect Services Company Limited ("GPS") is a private company. It has five independent shareholders each holding 20% equity interest in GPS. In the draft financial statements for the year ended 30 June 2008, GPS reported a net current liability of HK$30,000,000 and a negative equity (i.e. net liability) of HK$100,000,000. Current liabilities of GPS include amounts due to shareholders of HK$20,000,000. Non-current liabilities include shareholders' loans of HK$200,000,000, which do not have fixed repayment date, but are repayable if all the five shareholders demand repayment.

You are the auditor of GPS's financial statements for the year ended 30 June 2008. You have performed all the audit procedures you could have performed and are satisfied with the results. Based on the audit work performed, you consider GPS's financial statements comply with all the financial reporting standards.

Required:

Determine the type of opinion you would express. Draft the relevant paragraph in the auditor's report to illustrate.

(12 marks)

ANSWER 3

That GPS reported a net current liability and a net liability as at 30 June 2008 were, according to HKSA 570, conditions which may give rise to business risks that individually or collectively may cast significant doubt about application of the going concern assumption in preparing GPS financial statements for the year ended 30 June 2008.

The significance of such events or conditions was mitigated by the fact that the net current liability and net liability were mainly caused by the current and non-current liabilities due to GPS shareholders.

If the shareholders did not have the intention to demand for repayment of the amount due within the foreseeable future, there were no other indications that GPS might have going concern problems within the 12 months from the balance sheet date.

If the current amount due to shareholders of HK$20,000,000 were considered as equity, the net current liability would be reduced to HK$10,000,000.

If the non-current amount due to shareholders of HK$200,000,000 were considered as equity, GPS would have a positive equity of HK$100,000,000.

However, even though such mitigating factors exist, it is not likely that GPS (as well as its auditor) is able to conclude that there is no material uncertainty exists related to these conditions that may cast significant doubt on GPS's ability to continue as a going concern.

Therefore, provided that all the disclosure about the conditions that may cast significant doubt on GPS's ability to continue as a going concern have been properly made, the auditor should not qualify its opinion, but should modify it by adding an emphasis of matter immediately after the opinion to draw attention to the conditions.

The paragraph of emphasis of matter may read as follows:

"Without qualifying our opinion, we draw attention to Note [ ] in the financial statements which indicates that as at 30 June 2008 the Company's current liabilities exceeded its current assets by HK$30,000,000 and the Company's total liabilities exceeded its total assets by HK$100,000,000. These conditions, along with other matters as set forth in Note [ ], indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern."

Instead of drafting the paragraph of emphasis of matter, candidates may provide arguments against adding it, or suggest conditions under which there will be no material uncertainty as to GPS's ability to continue as a going concern. Marks should be appropriately awarded for such arguments or suggestions.

Q4) HKICPA QP Mod C Past Paper -Jun 2001

Mr. Chan is an experienced audit manager in a CPA firm. He has recently been asked by Mr. Leung, a partner of the firm, to act as the manager for a newly secured audit assignment on Retail Shop Limited, a company operating a chain of furniture retail outlets in Hong Kong.

Mr. Chan subsequently arranged a planning meeting with Mr. Wong, the financial controller. During the meeting, Mr. Wong informed Mr. Chan that Retail Shop Limited was founded by Mr. Lam three years ago. Over the three years, operating losses were incurred as a result of significant amounts being paid for outlet premises, leasehold improvement, promotion and advertising, staff training, and because of stock piling up. Retail Shop Limited relies on the point-of-sale terminals installed at the retail outlets for recording sale transactions, which automatically update the inventory control system, purchase order system, and the general ledger run on the central computer systems.

Currently, Mr. Lam's own savings, bank overdrafts supported by his personal guarantees and vendors' financing, are used to finance Retail Shop Limited. Mr. Wong is very confident that Retail Shop Limited has already passed its early development stage and should be able to turn into profit in the coming years. He also indicated that Retail Shop Limited is presently negotiating a long-term bank loan and is seriously considering a listing on the Growth Enterprises Market of the Stock Exchange of Hong Kong Limited.

Question:

As a result of this planning meeting, Mr. Chan has some concerns as to whether Retail Shop Limited will continue as a going concern for the foreseeable future. He also has doubts about the integrity of the data transmitted to the central computer systems from the point-of-sale terminals installed at the retail outlets. Draft a memorandum from Mr. Chan to Mr. Leung in which you:

(a) Explain the going concern indicators of Retail Shop Limited that Mr. Chan has identified during the planning meeting.

(7 marks)

(b) Set out the audit procedures to be performed in order to assess whether the going concern basis is appropriate.

(7 marks)

(c) Set out the potential problems that might result from automatic updating to other computer systems by the point-of-sale terminals installed at the retail outlets.

(3 marks)

ANSWER 4

MEMORANDUM

To : Mr. Leung, Partner

From : Mr. Chan, Audit Manager

10 September 2001

Re: Retail Shop Limited

I have completed a planning meeting with Mr. Wong, financial controller of Retail Shop Limited. Two issues of audit concern have arisen from this meeting. Firstly, the overall financial status of Retail Shop Limited suggests that the going concern viability of the enterprise must be carefully considered in the audit process. Secondly, there is a specific issue regarding the point-of-sale terminals update to the other computer systems that needs to be reviewed.

The going concern issue is exemplified by a reliance by Retail Shop Limited on its owner, Mr. Lam, for financing the concern from personal savings, as well as on its own bank overdraft and vendor credit extensions on payables. There has been a history of losses, although Mr. Wong believes that these are start-up difficulties and not representative of future results. There has been stock "piling up" suggesting possible inventory write-downs. Other general business conditions should be evaluated including the presence of competitors, the profit margin obtainable from operations, and the continued willingness of vendors to extend terms of credit. Mr. Wong did indicate that Retail Shop Limited is pursuing long-term bank loans and possibly considering a GEM listing on the Stock Exchange.

Audit procedures to determine whether or not to evaluate Retail Shop Limited as a going concern should consider the above, and conduct a review of management's plans to address operations, including profit margins, cost containment, and cash flow projections. In addition, bank facilities letters, minutes of the board of directors, and post-balance sheet date financial information should be reviewed in assessing the going concern viability of Retail Shop Limited. The ability of Mr. Lam and vendors, as well as of other third parties, to continue to finance the operations of Retail Shop Limited should also be considered. Written representations from management should be obtained on this going concern issue.

As to the point-of-sale terminals I believe we need to investigate physical access to the terminals at each of the Retail Shop Limited locations, as well as security of data transmissions to the central computer systems. The reliance on the computer systems to control inventory and stock ordering needs to be assessed for reliability and accuracy. The immediate update of the accounting records without additional verification by staff is also a concern which must be examined during the audit.

I hope the above information will help you appraise our major concerns about Retail Shop Limited's audit for this year. Please let me know if you wish to discuss further these or any other items regarding this client.

Mr. Chan

Question from HKICPA Learning Pack

Self-test question 2

OPR is a large private entity that manufactures steel and other products used in the construction of toll roads in China. During the course of the December 20Y0 audit of OPR, a prominent Hong Kong based infrastructure group announced that it intends to postpone indefinitely a major proposed toll road project in Southern China. You know that OPR's projections include a major share of the work expected to flow from this project.

The entity has already been experiencing some cash flow difficulties, although this is not unusual in the industry. Management has recently fully extended their overdraft facility in order to pay day-to-day expenses like wages and salaries. The audit partner is concerned that the entity may be facing going concern problems, but the chief executive officer maintains that future capital expenditure can be cut back to alleviate the going concern issue. In addition, surplus assets can be sold and long-term debt rescheduled if necessary.

Required

(a) The audit partner has asked you to investigate further the Chief Executive Officer claims. Prepare a list outlining the information and analysis you require the management to provide to you to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements.

(b) What are the possible mitigating factors that the chief executive officer has not yet mentioned?

(c) The managing director vehemently believes that, since the entity is privately held and all the shareholders are involved in the business, no disclosure of the entity's 's potential going concern problems is necessary. Provide a response to the Chief Executive Officer comments.

Answer 2

(a) In accordance with HKSA 570 (Clarified), when events or conditions have been identified which may cast significant doubt on OPR's ability to continue as a going concern, the auditor should undertake the following:

(i) Review management's plans for future actions based on its going concern assessment

(ii) Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of management and other mitigating factors

(iii) Seek written representations from management regarding its plans for future action.

In this case, the auditor should:

(i) inquire of management as to OPR's plans for future action, including its future plans to cut back capital expenditure, dispose of surplus assets and reschedule long-term debts

(ii) consider whether any additional facts or information are available since the date on which management made its assessment on OPR's as a going concern

(iii) obtain sufficient appropriate audit evidence that management's plans are feasible and that the outcome of these plans will improve the situation

Audit procedures that are relevant in this regard may, among others, include the following:

(i) Analysing and discussing cash flow, profit and other relevant forecasts with management

For this purpose, the auditor should consider:

– details of capital expenditure commitments and management's assessment of how crucial these expenditures are to the viability of the entity and evidence to support the entity's ability to cut back or defer capital expenditure commitments

– contracts and other documentation related to the proposed sale of surplus assets, and the management's assessment as to the feasibility of their plans to raise cash by such sales

(ii) Reviewing the terms of debentures and loan agreements. For this purpose, the auditor should consider:

- management's assessment of the feasibility of obtaining new or extended repayments terms for existing debt
- details of the existing loan agreement, the extent the facility has been utilised, and management's assessment on the possibility that extension will be granted by the lender
- details of the terms of any overdraft arrangements made by the entity
- the management's assessment of the possibility that the overdraft will exceed the facility limit

(iii) Analysing and discussing the entity's latest available interim financial statements

(iv) Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties

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(b) Additional mitigating factors might include the following:

(i) Identify whether there are plans to tender for other projects to replace the toll road project in Southern China and assess the capability of the entity to win such kind of projects;

(ii) The ability to raise additional equity;

(iii) The ability to further extend the credit period being taken from suppliers; conversely, the ability to improve debt collection;

(iv) The willingness of a third party or affiliated entity to guarantee the entity's liabilities.

(c) As OPR's auditor, we should disagree with the non-disclosure of the potential going concern problems for the following reasons:

(i) Although all shareholders are involved in the business, it remains the directors' responsibility to ensure the financial statements reflect a true and fair view

(ii) Hong Kong Accounting Standards require that when management is aware in making its assessment of material uncertainties related to events or conditions which may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties should be disclosed in order that the financial statements present a true and fair view

(iii) This requirement applies equally to all types of entity and to all entities through which business is carried out, regardless of their listed or non-listed status

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