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

MEMBERS' HANDBOOK

Update No. 118

(Issued 6 July 2012)

Document Reference and Title	***Instructions***	***Explanations***
VOLUME III		
Contents of Volume III	Discard the existing pages i to iv and replace with the new pages i to iv.	Revised contents pages
PREFACE TO THE HONG KONG QUALITY CONTROL, AUDITING, REVIEW, OTHER ASSURANCE AND RELATED SERVICES PRONOUNCEMENTS		
Amended Divider *Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*	Replace the existing Divider *Preface to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services* with the Amended Divider.	Amended Divider
Amended Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements	Replace the existing Preface with the Amended Preface.	Note 1
HONG KONG STANDARDS ON AUDITING		
HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	Insert the revised page 1 and discard the replaced page 1.	Note 3
HKSA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	Insert HKSA 315(Revised) after HKSA 315 (Clarified).	Note 2
HKSA 610 (Clarified) *Using the Work of Internal Auditors*	Insert the revised page 1 and discard the replaced page 1.	Note 3
HKSA 610 (Revised) *Using the Work of Internal Auditors*	Insert HKSA 610(Revised) after HKSA 610 (Clarified).	Note 2

HONG KONG STANDARDS ON RELATED SERVICES

HKSRS 4410 *Engagements to Compile Financial Statements*	Insert the revised page 1 and discard the replaced page 1.	Note 5
HKSRS 4410 (Revised) *Compilation Engagements*	Insert HKSRS 4410(Revised) after HKSRS 4410.	Note 4

PRACTICE NOTES

PN 1000 *Inter-bank confirmation procedures*	Discard PN 1000.	Note 1
PN 1010 *The Consideration of Environmental Matters in the Audit of Financial Statements*	Discard PN 1010.	Note 1
PN 1012 *Auditing Derivative Financial Instruments*	Discard PN 1012.	Note 1
PN 1013 *Electronic Commerce - Effect on the Audit of Financial Statements*	Discard PN 1013.	Note 1

HONG KONG AUDITING PRACTICE GUIDANCE

New Divider HONG KONG AUDITING PRACTICE GUIDANCE	Insert New Divider after AG 3.341.	New Divider
HKAPG 1000 *Special Considerations in Auditing Financial Instruments*	Insert these pages after New Divider.	New HKAPG – Note 1

Notes:

1. In December 2011, the International Auditing and Assurance Standards Board (IAASB) issued the International Auditing Practice Note (IAPN) 1000 *Special Considerations in Auditing Financial Instruments*. IAPNs are non-authoritative documents that do not impose additional requirements on auditors beyond those included in the International Standards on Auditing (ISAs), nor do they change the auditor's responsibility to comply with all ISAs relevant to the audit. In finalizing IAPN 1000, and in response to stakeholder concerns, the IAASB evaluated the clarity and appropriateness of the authority of the existing International Auditing Practice Statements (IAPSs). The IAASB decided to withdraw the existing category of pronouncements known as IAPSs and to establish IAPNs, as reflected in the amended *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* (International Preface). Accordingly, the existing IAPSs were also withdrawn as the IAASB determined that they were largely outdated and inconsistent with the text of the clarified ISAs.

   Accordingly, the *Preface to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance, and Related Services* is amended as *Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related* Services *Pronouncements* to align with the amended International Preface. The Auditing and Assurance Standards Committee (AASC) considers that IAPNs should be adopted in Hong Kong as non-authoritative guidance to members. For clarity and clear differentiation from locally developed Practice

Notes, the IAPNs adopted by the AASC are named "Hong Kong Auditing Practice Guidance" (HKAPG). HKAPG 1000 conforms with IAPN 1000 and it provides important practical assistance to auditors when addressing valuation and other considerations pertaining to financial instruments.

In addition, as a result of the withdrawal of the IAPSs, the Practice Notes which are adopted from the IAPSs are also withdrawn. These Practice Notes are:

- PN 1000 *Inter-bank confirmation procedures*
- PN 1010 *The Consideration of Environmental Matters in the Audit of Financial Statements*
- PN 1012 *Auditing Derivative Financial Instruments*
- PN 1013 *Electronic Commerce - Effect on the Audit of Financial Statements*

The authority of the locally developed Practice Notes remains unchanged.

2. HKSA 315 (Revised) and HKSA 610 (Revised) conform with ISA 315 (Revised) and ISA 610 (Revised) issued by the IAASB in March 2012. HKSA 610 (Revised) is aimed at enhancing the external auditor's performance by providing a more robust framework for evaluating and using the work of an entity's internal audit function. Related changes have also been made to HKSA 315 (Revised) to explain how the internal audit function and its findings can usefully inform the external auditor's risk assessments. Both HKSA 610 (Revised) and HKSA 315 (Revised) are effective for audits of financial statements for periods ending on or after 15 December 2013.

   In addition, HKSA 610 (Revised) gave rise to and contained conforming amendments to the following HKSAs which would be effective for audits of financial statements for periods ending on or after 15 December 2013:

   - HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*
   - HKSA 230, *Audit Documentation*
   - HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
   - HKSA 260, *Communication with Those Charged with Governance*
   - HKSA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*
   - HKSA 300, *Planning an Audit of Financial Statements*
   - HKSA 402, *Audit Considerations Relating to an Entity Using a Service Organization*
   - HKSA 500, *Audit Evidence*
   - HKSA 550, *Related Parties*
   - HKSA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

3. HKSA 315 (Clarified) and HKSA 610 (Clarified) are updated to reflect that they will be superseded by HKSA 315 (Revised) and HKSA 610 (Revised) respectively effective for audits of financial statements for periods ending on or after 15 December 2013.

4. HKSRS 4410 (Revised) conforms with ISRS 4410 (Revised) issued by the IAASB in March 2012. HKSRS 4410 (Revised) clarifies the practitioner's role and responsibilities in a compilation engagement and matters that need to be considered when accepting such engagements, and emphasizes the importance of quality control. It also expands the traditional compilation engagement report to make clear to users the practitioner's contribution to the compiled financial information presented by management, and the key features of a compilation engagement. HKSRS 4410 (Revised) is effective for compilation engagement reports dated on or after 1 July 2013.

5. HKSRS 4410 is updated to reflect that it will be superseded by HKSRS 4410 (Revised) effective for compilation engagement reports dated on or after 1 July 2013.

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

MEMBERS' HANDBOOK
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(Updated to July 2012)

		Issue/Review date

Amended Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements

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

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AMENDED PREFACE TO THE HONG KONG QUALITY CONTROL, AUDITING, REVIEW, OTHER ASSURANCE, AND RELATED SERVICES PRONOUNCEMENTS

Introduction

1. This Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements is issued to facilitate understanding of the scope and authority of the pronouncements the Hong Kong Institute of Certified Public Accountants (HKICPA) issues.

2. This Preface is issued to set out the objectives and due process of the Council of the HKICPA (hereafter referred as the "Council") in respect of setting Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements.

3. This Preface also sets out the relationship between Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements and International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants, and the authority attaching to locally developed Practice Notes (PNs), Auditing Guidelines (AGs), Auditing and Assurance Technical Bulletins and Circulars.

   Appendix 1 illustrates the structure of the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements.

Objectives of Council

4. Pursuant to section 18A of the Professional Accountants Ordinance, Council may, in relation to the practice of accountancy, issue or specify any standards of auditing practices required to be observed, maintained or otherwise applied by members of the HKICPA (members). Approval of Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements and related documents, such as exposure drafts, and other discussion documents, is the responsibility of Council.

5. Council has mandated the Auditing and Assurance Standards Committee (AASC) to develop Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements to achieve convergence with International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements. Within this remit, Council permits the AASC to work in whatever way it considers most effective and efficient and this may include forming advisory working groups or other forms of specialist advisory groups to give advice in preparing new and revised Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements.

6. The HKICPA's Standards and Quality Accountability Board (SQAB) is responsible for reviewing and advising on the HKICPA's overall strategy, policies and processes for setting Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements. One of the SQAB's main objectives is to give advice to the AASC on priorities and on major standard-setting projects.

7. In 2001, Council adopted the policy of achieving convergence of Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements with International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements (the Convergence). Council's objectives in this respect are:

   (a) to establish high quality auditing standards and guidance for financial statement audits that are generally accepted and recognized by investors, auditors, governments, regulators and other key stakeholders;

(b) to establish high quality standards and guidance for other types of assurance services on both financial and non-financial matters;

(c) to establish high quality standards and guidance for other related services;

(d) to establish high quality standards and guidance for quality control covering the scope of services addressed by the AASC;

(e) to publish other pronouncements on auditing and assurance matters, thereby advancing public understanding of the roles and responsibility of auditors and assurance service providers; and

(f) to bring about convergence of Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements with International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements.

Relationship with International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements

8. Although Council has a policy to achieve convergence of Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements with International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, Council may consider it appropriate to include additional requirements in a Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncement or, in some exceptional cases, to deviate from an International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncement. Each Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncement issued by Council contains information about the extent of conformity with the equivalent International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncement.

The HKICPA's Pronouncements

HKICPA Authoritative Pronouncements

9. The HKICPA's pronouncements govern audit, review, other assurance, and related services engagements that are conducted in accordance with Hong Kong Standards. They do not override the local laws or regulations that govern the audit of historical financial statements or assurance engagements on other information. In the event that local laws or regulations differ from, or conflict with, the HKICPA's Standards on a particular subject, an engagement conducted in accordance with local laws or regulations will not automatically comply with the HKICPA's Standards. A member should not represent compliance with the HKICPA's Standards unless the member has complied fully with all standards relevant to the engagement.

10. The authoritative pronouncements of the HKICPA include the Hong Kong Standards, locally developed PNs and AGs which are issued following the AASC's stated due process.

11. For the purpose of this Preface, the term "Hong Kong Standards" includes:

- Hong Kong Standards on Quality Control (HKSQCs);
- Hong Kong Framework for Assurance Engagements;
- Hong Kong Standards on Auditing (HKSAs);
- Hong Kong Standards on Review Engagements (HKSREs);
- Hong Kong Standards on Assurance Engagements (HKSAEs);
- Hong Kong Standards on Investment Circular Reporting Engagements (HKSIRs); and
- Hong Kong Standards on Related Services (HKSRSs).

The Authority Attaching to Hong Kong Standards Issued by the HKICPA

12. HKSAs are to be applied in the audit of historical financial information.

13. HKSREs are to be applied in the review of historical financial information.

14. HKSAEs are to be applied in assurance engagements other than audits or reviews of historical financial information.

15. HKSIRs are to be applied in investment circular reporting engagements.

16. HKSRSs are to be applied to compilation engagements, engagements to apply agreed upon procedures to information and other related services engagements as specified by the AASC.

17. HKSAs, HKSREs, HKSAEs, HKSIRs, and HKSRSs are collectively referred to as the Hong Kong Engagement Standards.

18. HKSQCs are to be applied for all services falling under the Hong Kong Engagement Standards.

Hong Kong Standards on Auditing

19. HKSAs are written in the context of an audit of financial statements[1] by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. The authority of HKSAs is set out in HKSA 200.[2]

Hong Kong Standards on Quality Control

20. HKSQCs are written to apply to firms in respect of all their services falling under the Hong Kong Engagement Standards. The authority of HKSQCs is set out in the introduction to the HKSQCs.

Other Hong Kong Standards

21. Some Hong Kong Standards identified in paragraphs 13–16 contain: objectives, requirements, application and other explanatory material, introductory material and definitions. These terms are to be interpreted in a directly analogous way to how they are explained in the context of HKSAs and financial statement audits in HKSA 200. (i.e. some standards are drafted using the same drafting conventions as the HKSAs (effective for audits of financial statements for periods beginning on or after 15 December 2009) and the structure of these standards is similar to that of the HKSAs. Therefore, the above terms in these Standards have similar meaning as the terms used in HKSAs.)

22. Other Hong Kong Standards identified in paragraphs 13–16 contain basic principles and essential procedures (identified in bold type lettering and by the word "should") together with related guidance in the form of explanatory and other material, including appendices. The basic principles and essential procedures are to be understood and applied in the context of the explanatory and other material that provides guidance for their application. It is therefore necessary to consider the entire text of a Standard to understand and apply the basic principles and essential procedures.

23. The basic principles and essential procedures of a Standard are to be applied in all cases where they are relevant in the circumstances of the engagement. In exceptional circumstances, however, a member may judge it necessary to depart from a relevant essential procedure in order to achieve the purpose of that procedure. When such a situation arises, the member is required to document how alternative procedures performed achieve

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[1] Unless otherwise stated, "financial statements" mean financial statements comprising historical financial information.

[2] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*

the purpose of the procedure and, unless otherwise clear, the reasons for the departure. The need for the member to depart from a relevant essential procedure is expected to arise only where, in the specific circumstances of the engagement, that procedure would be ineffective.

24. Appendices, which form part of the application material, are an integral part of a Standard. The purpose and intended use of an appendix are explained in the body of the related Standard or within the title and introduction of the appendix itself.

Professional Judgment

25. The nature of the Hong Kong Standards requires the member to exercise professional judgment in applying them.

Applicability of the Hong Kong Standards

26. The scope, effective date and any specific limitation of the applicability of a specific Hong Kong Standard is made clear in the Standard. Unless otherwise stated in the Hong Kong Standard, the member is permitted to apply a Hong Kong Standard before the effective date specified therein.

27. Hong Kong Standards are relevant to engagements in the public sector. When appropriate, additional considerations specific to public sector entities are included:

    (a) Within the body of a Hong Kong Standard in the case of HKSAs and HKSQCs; or

    (b) In a Public Sector Perspective (PSP) appearing at the end of other Hong Kong Standards.

28. Exposure drafts are issued for comment and their proposals are subject to revision. Until the effective date of a Hong Kong Standard, the requirements of any Hong Kong Standards that would be affected by proposals in an exposure draft remain in force.

The Authority Attaching to Practice Notes and Auditing Guidelines Locally Developed by the AASC

29. PNs and AGs are issued to provide interpretative guidance and practical assistance to members in implementing Hong Kong Engagement Standards and to promote good practice. PNs and AGs are local guidance developed by the AASC in response to emerging regulatory issues or new reporting requirements.

30. Members should be aware of and consider PNs and AGs applicable to the engagement. A member who does not consider and apply the guidance included in a relevant PN/AG should be prepared to explain how the basic principles and essential procedures in the Hong Kong Engagement Standard(s) addressed by the PN/AG have been complied with.

Obligation for Members to Observe HKICPA Authoritative Pronouncements or Justify Departures

31. Council is committed to promoting and supporting compliance with Hong Kong Standards by members. Council therefore expects members to observe Hong Kong Standards.

32. Apparent failures by members to comply with Hong Kong Standards are liable to be enquired into by the appropriate committee established under the authority of the HKICPA, and disciplinary action may result.

33. Members who do not comply with Hong Kong Standards make themselves liable to disciplinary action which may include the withdrawal of a practising certificate and hence of eligibility to perform audits.

34. Relevant Hong Kong Standards are likely to be taken into account when the adequacy of the work of members is being considered in a court of law or in other contested situations.

Compliance with a standard other than Hong Kong Standards

35. Where a member states that he has conducted an engagement in compliance with a standard other than Hong Kong Standards, for example International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (International Standards), the engagement must have in fact been so conducted and the engagement report must in fact have so conformed.

Application of HKSAs to the audits of overseas enterprises

36. Where the financial statements of an overseas enterprise are to be incorporated into Hong Kong financial statements, the audit of the overseas enterprise should conform to HKSAs in so far as this is necessary to ensure that the audit of the Hong Kong financial statements as a whole is in accordance with HKSAs.

37. Where the financial statements of an overseas incorporated enterprise are audited by Hong Kong auditors (as represented by signing the auditor’s report in the style "Certified Public Accountant(s) (Practising), Hong Kong" or “Certified Public Accountant(s), Hong Kong”) the audit of the enterprise should conform to HKSAs.

38. Where the financial statements of an overseas/People’s Republic of China incorporated enterprise which is listed on The Stock Exchange of Hong Kong are audited by Hong Kong auditors (as represented by signing the auditor’s report in the style "Certified Public Accountant(s) (Practising), Hong Kong" or “Certified Public Accountant(s), Hong Kong”), the relevant Listing Rules allow the audit to conform to International Standards on Auditing.

39. There may be circumstances, however, where an audit is being carried out of an overseas enterprise for purposes other than Hong Kong reporting. In these cases, the audit should conform to appropriate standards as follows:

(a) where the local audit requirements and standards are properly codified and defined, the audit may conform to those standards; and

(b) in the absence of such local requirements and standards, the audit should conform to HKSAs or International Standards on Auditing or other auditing standards established by an organization that is authorized or recognized to promulgate auditing standards.

In any event, the auditor’s report should specify under which auditing standards the audit has been carried out.

Non-Authoritative Material

40. Non-authoritative material includes Practice Guidance (equivalent of IAASB's Practice Notes), locally developed Auditing and Assurance Technical Bulletins, Circulars and staff publications. Non-authoritative material is not part of the HKICPA’s Hong Kong Standards.

Hong Kong Auditing Practice Guidance

41. The IAASB develops and publishes non-authoritative International Auditing Practice Notes (IAPNs). IAPNs do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with all ISAs relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

42. The AASC considers that IAPNs should be adopted in Hong Kong as non-authoritative guidance to members. For clarity and clear differentiation from locally developed PNs, the IAPNs adopted by the AASC are named "Hong Kong Auditing Practice Guidance" (HKAPG).

43. Depending on the nature of the topic(s) covered, a HKAPG may assist the auditor in:

- Obtaining an understanding of the circumstances of the entity, and in making judgments about the identification and assessment of risks of material misstatement;
- Making judgments about how to respond to assessed risks, including judgments about procedures that may be appropriate in the circumstances; or
- Addressing reporting considerations, including forming an opinion on the financial statements and communicating with those charged with governance.

Practice Guidance Relating to Other Hong Kong Standards

44. The IAASB may also issue International Review Engagement Practice Notes (IREPNs), International Assurance Engagement Practice Notes (IAEPNs), and International Related Services Practice Notes (IRSPNs) to serve the same purpose for ISREs, ISAEs, and ISRSs respectively. In this regard, the AASC would also adopt the IREPNs, IAEPNs and IRSPNs as Hong Kong Review Engagement Practice Guidance (HKREPG), Hong Kong Assurance Engagement Practice Guidance (HKAEPG), and Hong Kong Related Services Practice Guidance (HKRSPG) accordingly.

Auditing and Assurance Technical Bulletins and Circulars Locally Developed by the AASC

45. Auditing and Assurance Technical Bulletins and Circulars are informative publications issued by the AASC on subjects of topical interest and are intended to assist members or to stimulate debate on auditing and assurance issues. They do not have the same authority as the HKICPA's authoritative pronouncements.

Staff Publications

46. Staff publications (including those issued by IAASB) are used to help raise practitioners' awareness of significant new or emerging issues by referring to existing requirements and application material, or to direct their attention to relevant provisions of HKICPA pronouncements.

Due process

47. The HKICPA's authoritative pronouncements are developed through a due process that involves members and other interested individuals and organizations.

48. The AASC consults the Standards and Quality Accountability Board on major projects, agenda decisions and work priorities.

49. Appendix 2 illustrates the due process to adopt IAASB authoritative pronouncements.

50. Appendix 3 illustrates the due process for the development of local PNs.

Coordination with International Due Process

51. Council understands that close coordination between the AASC's and IAASB's due processes is important to the success of achieving convergence of Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements with International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements.

52. Council supports the integration of its standard setting process with that of the IAASB as outlined below by adopting the procedures in paragraphs 53 to 55.

53. The IAASB states in its Terms of Reference that it cooperates with national standard setters to link their work with IAASB's own in preparing and issuing International Standards with an aim to share resources, minimize duplication of effort and reach consensus and convergence in standards at an early stage in their development. It also promotes the endorsement of International Standards by national standard setters, legislators and securities exchanges and promotes debate with users, regulators and practitioners throughout the world to identify user needs for new International Standards and guidance.

54. The IAASB would continue to publish its own exposure drafts and other documents for public comment and national standard setters would publish their own exposure documents at approximately the same time as IAASB exposure drafts and would seek specific comments on any significant divergences between the two exposure documents. In some instances, national standard setters may include in their exposure documents specific comments on issues of particular relevance to their country or include more detailed guidance than is included in the corresponding IAASB document.

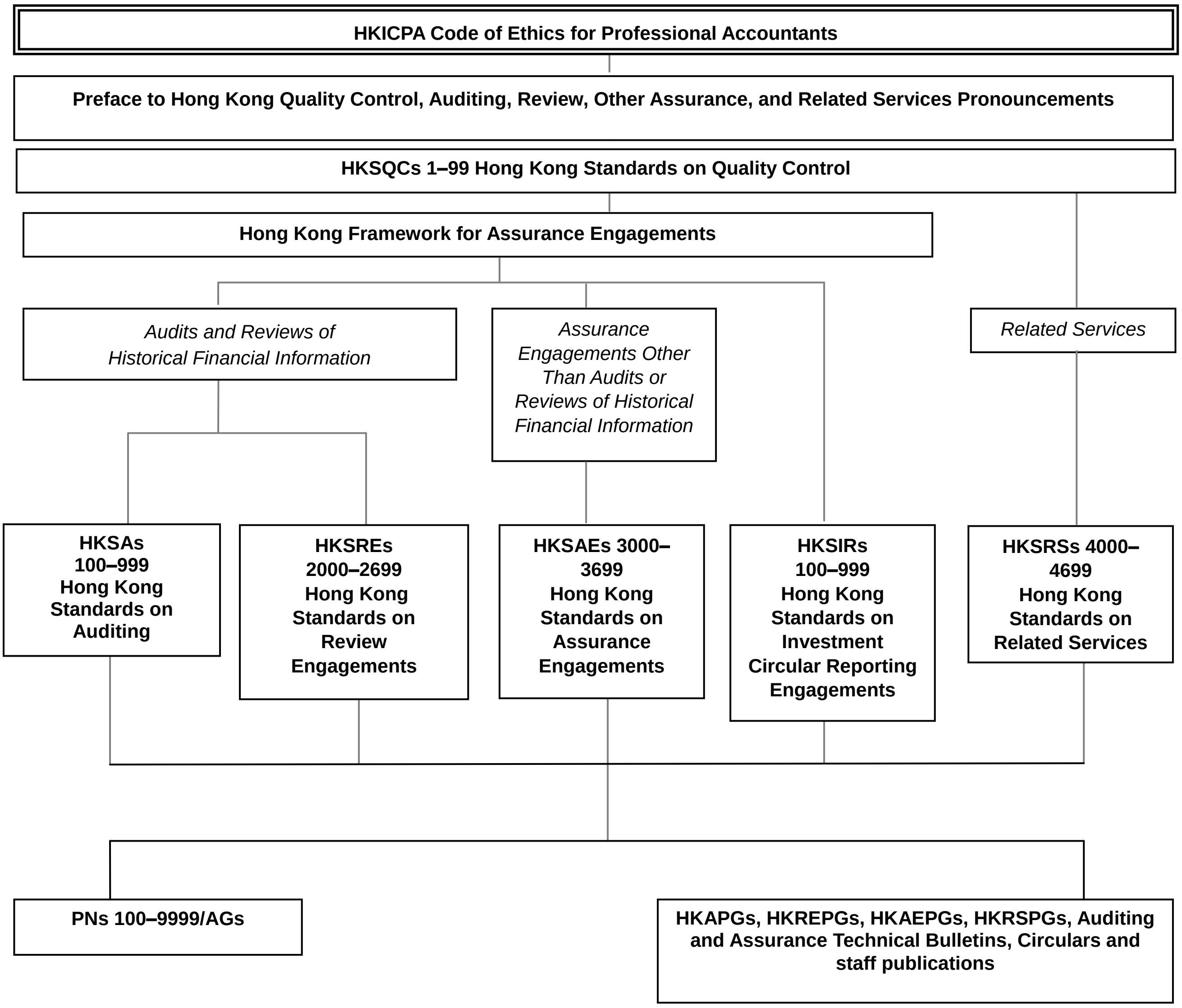
55. National standard setters would follow their own full due process, which they would, ideally, choose to integrate with the IAASB's due process. This integration would avoid unnecessary delays in completing standards and would also minimize the likelihood of unnecessary differences between the standards that result.

Effective date

56. This Preface is effective upon issue.

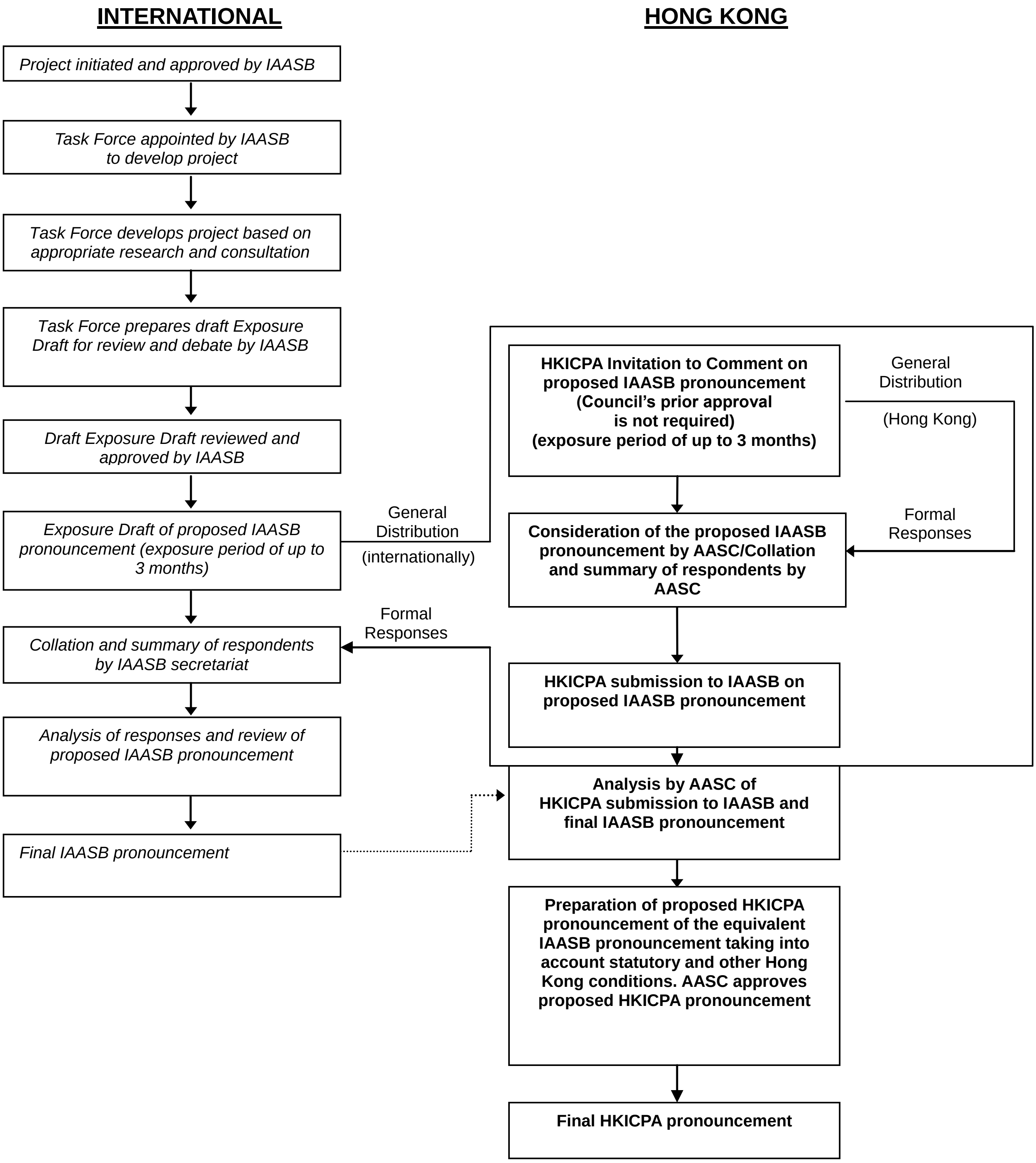
APPENDIX 1

Structure of Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements



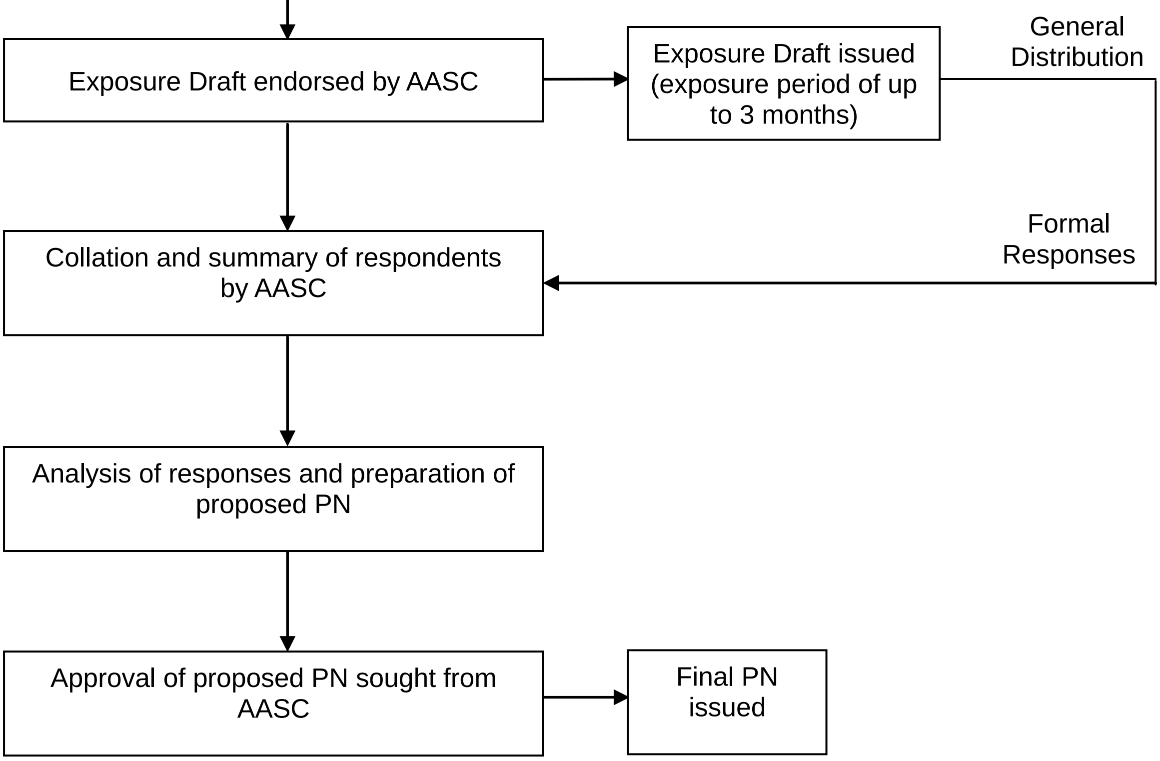
APPENDIX 2

Auditing and Assurance Standards Committee Due Process to Adopt IAASB Pronouncements



APPENDIX 3

Auditing and Assurance Standards Committee
Due Process for the Development of Local Practice Notes



HKSA 315
Issued June 2009; revised July 2010, July 2012

Effective for audits of financial statements
for periods beginning on or after 15 December 2009*

Hong Kong Standard on Auditing 315

Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

* HKSA 315 is applicable for audits of financial statements for periods beginning on or after 15 December 2009 but before 15 December 2013. HKSA 315 (Revised) is applicable for audits of financial statements for periods beginning on or after 15 December 2013.

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

HKSA 315 (Revised)
Revised July 2012

Effective for audits of financial statements
for periods ending on or after 15 December 2013

Hong Kong Standard on Auditing 315 (Revised)

Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

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The Hong Kong Standard on Auditing 315 (Revised) is based on International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* of the International Auditing and Assurance Standards Board, published by the International Federation of Accountants (IFAC) in March 2012 and is used with permission of IFAC.

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HONG KONG STANDARD ON AUDITING 315 (REVISED)

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

(Effective for audits of financial statements for periods ending on or after 15 December 2013)

CONTENTS

Hong Kong Standard on Auditing (HKSA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Effective Date

2. This HKSA is effective for audits of financial statements for periods ending on or after 15 December 2013.

Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Definitions

4. For purposes of the HKSAs, the following terms have the meanings attributed below:

   (a) Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

   (b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

   (c) Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.

   (d) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

   (e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1–A5)

6. The risk assessment procedures shall include the following:

   (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6–A13)

   (b) Analytical procedures. (Ref: Para. A14–A17)

   (c) Observation and inspection. (Ref: Para. A18)

7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.

8. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.

9. Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A19–A20)

10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A21–A23)

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:

   (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A24–A29)

   (b) The nature of the entity, including:

      (i) its operations;

      (ii) its ownership and governance structures;

      (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and

(iv) the way that the entity is structured and how it is financed,

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A30–A34)

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A35)

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A36–A42)

(e) The measurement and review of the entity's financial performance. (Ref: Para. A43–A48)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A49–A72)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A73–A75)

Components of Internal Control

Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:

(a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and

(b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A76–A86)

The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:

(a) Identifying business risks relevant to financial reporting objectives;

(b) Estimating the significance of the risks;

(c) Assessing the likelihood of their occurrence; and

(d) Deciding about actions to address those risks. (Ref: Para. A87)

16. If the entity has established such a process (referred to hereafter as the "entity's risk assessment process"), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity's risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity's risk assessment process.

17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A88)

The information system, including the related business processes, relevant to financial reporting, and communication

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

    (a) The classes of transactions in the entity's operations that are significant to the financial statements;

    (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;

    (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;

    (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;

    (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and

    (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A89–A93)

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A94–A95)

    (a) Communications between management and those charged with governance; and

    (b) External communications, such as those with regulatory authorities.

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A96–A102)

21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A103–A105)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A106–A108)

23. If the entity has an internal audit function,[1] the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A109–A116)

24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A117)

Identifying and Assessing the Risks of Material Misstatement

25. The auditor shall identify and assess the risks of material misstatement at:

    (a) the financial statement level; and (Ref: Para. A118–A121)

    (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A122–A126)

    to provide a basis for designing and performing further audit procedures.

26. For this purpose, the auditor shall:

    (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A127–A128)

    (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

    (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A129–A131)

    (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Risks that Require Special Audit Consideration

27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.

[1] HKSA 610 (Revised), *Using the Work of Internal Auditors*, paragraph 14, defines the term "internal audit function" for purposes of the HKSAs.

28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:

    (a) Whether the risk is a risk of fraud;

    (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;

    (c) The complexity of transactions;

    (d) Whether the risk involves significant transactions with related parties;

    (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

    (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A132–A136)

29. If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A137–A139)

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A140–A142)

Revision of Risk Assessment

31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A143)

Documentation

32. The auditor shall include in the audit documentation:[2]

    (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;

    (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14–24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;

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[2] HKSA 230, *Audit Documentation*, paragraphs 8–11, and A6

(c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and

(d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30. (Ref: Para. A144–A147)

Conformity and Compliance with International Standards on Auditing

33. As of July 2012 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 315 (Revised), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment". Compliance with the requirements of this HKSA ensures compliance with ISA 315 (Revised).

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Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

A1. Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with HKSA 320;[3]
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

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3 HKSA 320, *Materiality in Planning and Performing an Audit*

A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this HKSA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.

A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this HKSA. However, the significance of fraud is such that further requirements and guidance are included in HKSA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud. [4]

A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11–24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:

- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

Inquiries of Management, the Internal Audit Function and Others within the Entity (Ref: Para. 6(a))

A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.

A7. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. HKSA 260[5] identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

[4] HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 12–24

[5] HKSA 260, *Communication with Those Charged with Governance*, paragraph 4(b)

- Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.

- Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.

A8. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

Inquiries of the Internal Audit Function

A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.[6] Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.

A10. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.

A11. In addition, in accordance with HKSA 240,[7] if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.

A12. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities (Ref: Para 6(a))

A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

Analytical Procedures (Ref: Para. 6(b))

A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include

[6] The relevant requirements are contained in HKSA 610 (Revised).

[7] HKSA 240, paragraph 19

both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

A15. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

A16. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller Entities

A17. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and Inspection (Ref: Para. 6(c))

A18. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:

- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 9)

A19. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

A20. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion among the Engagement Team (Ref: Para. 10)

A21. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.

- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.

- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.

- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

HKSA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.[8]

A22. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A23. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

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8 HKSA 240, paragraph 15

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 11(a))

Industry Factors

A24. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

A25. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience.[9]

Regulatory Factors

A26. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- Accounting principles and industry-specific practices.
- Regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

A27. HKSA 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.[10]

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[9] HKSA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

[10] HKSA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 12

Considerations specific to public sector entities

A28. For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other External Factors

A29. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Nature of the Entity (Ref: Para. 11(b))

A30. An understanding of the nature of an entity enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example, with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.

- The ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately. HKSA 550[11] establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A31. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations such as:

    - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.

    - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).

    - Alliances, joint ventures, and outsourcing activities.

    - Geographic dispersion and industry segmentation.

    - Location of production facilities, warehouses, and offices, and location and quantities of inventories.

    - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post- employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).

    - Research and development activities and expenditures.

    - Transactions with related parties.

[11] HKSA 550, *Related Parties*

- Investments and investment activities such as:
  - Planned or recently executed acquisitions or divestitures.
  - Investments and dispositions of securities and loans.
  - Capital investment activities.
  - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- Financing and financing activities such as:
  - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
  - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
  - Beneficial owners (local, foreign, business reputation and experience) and related parties.
  - Use of derivative financial instruments.
- Financial reporting such as:
  - Accounting principles and industry-specific practices, including industry-specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition practices.
  - Accounting for fair values.
  - Foreign currency assets, liabilities and transactions.
  - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A32. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A33. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As HKSA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.[12]

[12] HKSA 550, paragraph A7

A34. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

The Entity's Selection and Application of Accounting Policies (Ref: Para. 11(c))

A35. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

- The methods the entity uses to account for significant and unusual transactions.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

Objectives and Strategies and Related Business Risks (Ref: Para. 11(d))

A36. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

A37. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change may also give rise to business risk. Business risk may arise, for example, from:

- The development of new products or services that may fail;
- A market which, even if successfully developed, is inadequate to support a product or service; or
- Flaws in a product or service that may result in liabilities and reputational risk.

A38. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

A39. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).

- New products and services (a potential related business risk might be, for example, that there is increased product liability).

- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).

- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).

- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).

- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).

- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A40. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

A41. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A87–A88.

Considerations Specific to Public Sector Entities

A42. For the audits of public sector entities, "management objectives" may be influenced by concerns regarding public accountability and may include objectives which have their source in law, regulation or other authority.

Measurement and Review of the Entity's Financial Performance (Ref: Para. 11(e))

A43. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. See HKSA 240 for requirements and guidance in relation to the risks of fraud.

A44. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A106–A117), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.

A45. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity's performance with that of competitors.

A46. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A47. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations Specific to Smaller Entities

A48. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control (Ref: Para. 12)

A49. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.

A50. The following application material on internal control is presented in four sections, as follows:

- General Nature and Characteristics of Internal Control.
- Controls Relevant to the Audit.
- Nature and Extent of the Understanding of Relevant Controls.
- Components of Internal Control.

General Nature and Characteristics of Internal Control

Purpose of Internal Control

A51. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

- The reliability of the entity's financial reporting;
- The effectiveness and efficiency of its operations; and
- Its compliance with applicable laws and regulations.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Considerations specific to smaller entities

A52. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of Internal Control

A53. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

A54. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

A55. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

A56. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

A57. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of Internal Control into Components

A58. The division of internal control into the following five components, for purposes of the HKSAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(a) The control environment;

(b) The entity's risk assessment process;

(c) The information system, including the related business processes, relevant to financial reporting, and communication;

(d) Control activities; and

(e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this HKSA, provided all the components described in this HKSA are addressed.

A59. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A76–A117 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment

A60. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A61. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.

- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

A62. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A63. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A64. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

A65. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

A66. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

A67. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A68. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

- Materiality.
- The significance of the related risk.
- The size of the entity.
- The nature of the entity's business, including its organization and ownership characteristics.
- The diversity and complexity of the entity's operations.
- Applicable legal and regulatory requirements.
- The circumstances and the applicable component of internal control.
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.
- Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.

A69. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A70. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

A71. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

Considerations Specific to Public Sector Entities

A72. Public sector auditors often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice. Public sector auditors can also have responsibilities to report on compliance with law, regulation or other authority. As a result, their review of internal control may be broader and more detailed.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A73. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A74. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

A75. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A62), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in HKSA 330.[13]

[13] HKSA 330, *The Auditor's Responses to Assessed Risks*

Components of Internal Control—Control Environment (Ref: Para. 14)

A76. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A77. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

(a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.

(b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(c) *Participation by those charged with governance* – Attributes of those charged with governance such as:

- Their independence from management.
- Their experience and stature.
- The extent of their involvement and the information they receive, and the scrutiny of activities.
- The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.

(d) *Management's philosophy and operating style* – Characteristics such as management's:

- Approach to taking and managing business risks.
- Attitudes and actions toward financial reporting.
- Attitudes toward information processing and accounting functions and personnel.

(e) *Organizational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.

(f) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.

(g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit Evidence for Elements of the Control Environment

A78. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

A79. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

Effect of the Control Environment on the Assessment of the Risks of Material Misstatement

A80. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework.

A81. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

A82. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in HKSA 330, the control environment also influences the nature, timing and extent of the auditor's further procedures.[14]

A83. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

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[14] HKSA 330, paragraphs A2–A3

Considerations Specific to Smaller Entities

A84. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small entity; it may, however, increase other risks, for example, the risk of override of controls.

A85. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

A86. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15)

A87. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations Specific to Smaller Entities (Ref: Para. 17)

A88. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

Components of Internal Control—The Information System, Including Related Business Processes, Relevant to Financial Reporting, and Communication

The Information System, Including Related Business Processes, Relevant to Financial Reporting (Ref: Para. 18)

A89. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;

- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and

- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

Journal entries

A90. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A91. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes

A92. An entity's business processes are the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;

- Ensure compliance with laws and regulations; and

- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities

A93. Information systems and related business processes relevant to financial reporting in small entities are likely to be less sophisticated than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's systems and processes may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

A94. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A95. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities Relevant to the Audit (Ref: Para. 20)

A96. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

- Authorization.
- Performance reviews.
- Information processing.
- Physical controls.
- Segregation of duties.

A97. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- Those that are considered to be relevant in the judgment of the auditor.

A98. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A99. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A100. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations Specific to Smaller Entities

A101. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A102. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks Arising from IT (Ref: Para. 21)

A103. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.

A104. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations.
- System software acquisition, change and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A63 above.

A105. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 22)

A106. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A107. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations Specific to Smaller Entities

A108. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

The Entity's Internal Audit Function (Ref: Para. 23)

A109. If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this HKSA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

A110. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.

A111. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

A112. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this HKSA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.

A113. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.

A114. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, HKSA 610 (Revised) applies.

A115. As is further discussed in HKSA 610 (Revised), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A116. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. HKSA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

Sources of Information (Ref: Para. 24)

A117. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- the sources of the information related to the entity's monitoring activities; and
- the basis upon which management considers the information to be sufficiently reliable for the purpose,

is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25(a))

A118. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A119. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A120. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

A121. HKSA 705[15] establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 25(b))

A122. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A123. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

A124. Assertions used by the auditor to consider the different types of potential misstatements that may occur fall into the following three categories and may take the following forms:

(a) Assertions about classes of transactions and events for the period under audit:

(i) Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.

(ii) Completeness—all transactions and events that should have been recorded have been recorded.

(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

(iv) Cutoff—transactions and events have been recorded in the correct accounting period.

(v) Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

(i) Existence—assets, liabilities, and equity interests exist.

(ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

[15] HKSA 705, *Modifications to the Opinion in the Independent Auditor's Report*

(c) Assertions about presentation and disclosure:

(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) Completeness—all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

A125. The auditor may use the assertions as described above or may express them differently provided all aspects described above have been covered. For example, the auditor may choose to combine the assertions about transactions and events with the assertions about account balances.

Considerations specific to public sector entities

A126. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A124, management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))

A127. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed.

A128. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement.

Relating Controls to Assertions (Ref: Para. 26(c))

A129. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A130. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A131. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks

Identifying Significant Risks (Ref: Para. 28)

A132. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A133. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A134. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

A135. HKSA 330 describes the consequences for further audit procedures of identifying a risk as significant.[16]

Significant risks relating to the risks of material misstatement due to fraud

A136. HKSA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.[17]

Understanding Controls Related to Significant Risks (Ref: Para. 29)

A137. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor’s understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- Control activities such as a review of assumptions by senior management or experts.
- Documented processes for estimations.
- Approval by those charged with governance.

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[16] HKSA 330, paragraphs 15 and 21
[17] HKSA 240, paragraphs 25–27

A138. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A139. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.[18]

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 30)

A140. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A141. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.

- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

A142. The consequences for further audit procedures of identifying such risks are described in HKSA 330.[19]

Revision of Risk Assessment (Ref: Para. 31)

A143. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See HKSA 330 for further guidance.

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[18] HKSA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

[19] HKSA 330, paragraph 8

Documentation (Ref: Para. 32)

A144. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.[20] Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.[21] The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A145. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A146. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of HKSA 230 are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A147. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

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20 HKSA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

21 HKSA 330, paragraph 28

Appendix 1

(Ref: Para. 4(c), 14–24, A76–A117)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14–24 and A76–A117, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:

    (a) *Communication and enforcement of integrity and ethical values*. The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.

    (b) *Commitment to competence*. Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.

    (c) *Participation by those charged with governance*. An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.

    (d) *Management's philosophy and operating style*. Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.

    (e) *Organizational structure*. Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.

    (f) *Assignment of authority and responsibility*. The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

(g) *Human resource policies and practices*. Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.

4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment*. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.

- *New personnel*. New personnel may have a different focus on or understanding of internal control.

- *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to internal control.

- *Rapid growth*. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.

- *New technology*. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.

- *New business models, products, or activities*. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.

- *Corporate restructurings*. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.

- *Expanded foreign operations*. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.

- *New accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).

6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:

   - Identify and record all valid transactions.

   - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.

   - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.

   - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.

   - Present properly the transactions and related disclosures in the financial statements.

7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.

8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

   - *Performance reviews*. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.

   - *Information processing*. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- *Physical controls*. Controls that encompass:
  - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
  - The authorization for access to computer programs and data files.
  - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

  The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.

12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A40, A128)

Conditions and Events That May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.

- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

HKSA 610
Issued July 2009; revised July 2010, July 2012

Effective for audits of financial statements
for periods beginning on or after 15 December 2009*

Hong Kong Standard on Auditing 610

Using the Work of Internal Auditors

* HKSA 610 is applicable for audits of financial statements for periods beginning on or after 15 December 2009 but before 15 December 2013. HKSA 610 (Revised) is applicable for audits of financial statements for periods beginning on or after 15 December 2013.

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

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Hong Kong Standard on Auditing 610 (Revised)

Using the Work of Internal Auditors

Conforming Amendments to Other HKSAs

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HONG KONG STANDARD ON AUDITING 610 (REVISED)

USING THE WORK OF INTERNAL AUDITORS

(Effective for audits of financial statements for periods ending on or after 15 December 2013)

CONTENTS

Hong Kong Standard on Auditing (HKSA) 610 (Revised), *Using the Work of Internal Auditors*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the external auditor's responsibilities if using the work of the internal audit function in obtaining audit evidence.

2. This HKSA does not apply if the entity does not have an internal audit function. (Ref: Para. A2)

3. If the entity has an internal audit function, the requirements in this HKSA do not apply if:

   (a) The responsibilities and activities of the function are not relevant to the audit; or

   (b) Based on the auditor's preliminary understanding of the function obtained as a result of procedures performed under HKSA 315 (Revised),[1] the external auditor does not expect to use the work of the function in obtaining audit evidence.

   Nothing in this HKSA requires the external auditor to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; it remains a decision of the external auditor in establishing the overall audit strategy.

4. In some jurisdictions, the external auditor may be prohibited, or restricted to some extent, by law or regulation from using the work of the internal audit function. The HKSAs do not override laws or regulations that govern an audit of financial statements.[2] Such prohibitions or restrictions will therefore not prevent the external auditor from complying with the HKSAs.

Relationship between HKSA 315 (Revised) and HKSA 610 (Revised)

5. Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance.

6. HKSA 315 (Revised) addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment and identification and assessment of risks of material misstatement. HKSA 315 (Revised)[3] also explains how effective communication between the internal and external auditors also creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.

7. Depending on whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competency of the internal audit function, and whether the function applies a systematic and disciplined approach, the external auditor may also be able to use the work of the internal audit function in a constructive and complementary manner. This HKSA addresses the external auditor's responsibilities when, based on the external auditor's preliminary understanding of the internal audit function obtained as a result of procedures performed under HKSA 315 (Revised), the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained.[4] Such use of that work modifies the nature or

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[1] HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

[2] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph A55

[3] HKSA 315 (Revised), paragraph A116

[4] See paragraphs 13–23.

timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.

8. There may be individuals in an entity that perform procedures similar to those performed by an internal audit function. However, unless performed by an objective and competent function that applies a systematic and disciplined approach, including quality control, such procedures would be considered internal controls and obtaining evidence regarding the effectiveness of such controls would be part of the auditor's responses to assessed risks in accordance with HKSA 330.[5]

The External Auditor's Responsibility for the Audit

9. The external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the external auditor's use of the work of the internal audit function on the engagement. Although the function may perform audit procedures similar to those performed by the external auditor, neither the internal audit function nor the internal auditors are independent of the entity as is required of the external auditor in an audit of financial statements in accordance with HKSA 200.[6] This HKSA, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of the internal audit function to prevent over or undue use of such work.

Effective Date

10. This HKSA is effective for audits of financial statements for periods ending on or after 15 December 2013.

Objectives

11. The objectives of the external auditor, where the entity has an internal audit function and the external auditor expects to use the work of the function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor are:

    (a) To determine whether the work of the internal audit function can be used, and if so, in which areas and to what extent;

    and having made that determination:

    (b) If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit.

Definition

12. For purposes of the HKSAs, the following term has the meaning attributed below:

    Internal audit function – A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes. (Ref: Para. A1–A4)

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[5] HKSA 330, *The Auditor's Responses to Assessed Risk*

[6] HKSA 200, paragraph 14

Requirements

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

13. The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

    (a) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; (Ref: Para. A5–A9)

    (b) The level of competence of the internal audit function; and (Ref: Para. A5–A9)

    (c) Whether the internal audit function applies a systematic and disciplined approach, including quality control. (Ref: Para. A10–A11)

14. The external auditor shall not use the work of the internal audit function if the external auditor determines that:

    (a) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

    (b) The function lacks sufficient competence; or

    (c) The function does not apply a systematic and disciplined approach, including quality control. (Ref: Para. A12–A14)

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

15. As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan. (Ref: Para. A15–A17)

16. The external auditor shall make all significant judgments in the audit engagement and, to prevent undue use of the work of the internal audit function, shall plan to use less of the work of the function and perform more of the work directly: (Para Ref: A15–A17)

    (a) The more judgment is involved in:

        (i) Planning and performing relevant audit procedures; and

        (ii) Evaluating the audit evidence gathered; (Ref: Para. A18–A19)

    (b) The higher the assessed risk of material misstatement at the assertion level, with special consideration given to risks identified as significant; (Para Ref: A20–A22)

    (c) The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors; and

    (d) The lower the level of competence of the internal audit function.

17. The external auditor shall also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. (Ref: Para. A15–A22)

18. The external auditor shall, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with HKSA 260,[7] communicate how the external auditor has planned to use the work of the internal audit function. (Ref: Para. A23)

Using the Work of the Internal Audit Function

19. If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned use of its work with the function as a basis for coordinating their respective activities. (Ref: Para. A24–A26)

20. The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures it performed and the related findings.

21. The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether:

    (a) The work of the function had been properly planned, performed, supervised, reviewed and documented;

    (b) Sufficient appropriate evidence had been obtained to enable the function to draw reasonable conclusions; and

    (c) Conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed. (Ref: Para. A27–A30)

22. The nature and extent of the external auditor's audit procedures shall be responsive to the external auditor's evaluation of:

    (a) The amount of judgment involved;

    (b) The assessed risk of material misstatement;

    (c) The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and

    (d) The level of competence of the function;[8] (Ref: Para. A27–A29)

    and shall include reperformance of some of the work. (Ref: Para. A30)

23. The external auditor shall also evaluate whether the external auditor's conclusions regarding the internal audit function in paragraph 13 of this HKSA and the determination of the nature and extent of use of the work of the function for purposes of the audit in paragraphs 16–17 of this HKSA remain appropriate.

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7 HKSA 260, *Communication with Those Charged with Governance*, paragraph 15

8 See paragraph 16.

Documentation

24. If the external auditor uses the work of the internal audit function, the external auditor shall include in the audit documentation:

    (a) The evaluation of:

        (i) Whether the function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors;

        (ii) The level of competence of the function; and

        (iii) Whether the function applies a systematic and disciplined approach, including quality control;

    (b) The nature and extent of the work used and the basis for that decision; and

    (c) The audit procedures performed by the external auditor to evaluate the adequacy of the work used.

Conformity and Compliance with International Standards on Auditing

25. As of July 2012 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 610 (Revised), "Using the Work of Internal Auditors". Compliance with the requirements of this HKSA ensures compliance with ISA 610 (Revised).

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Application and Other Explanatory Material

Definition of Internal Audit Function (Ref: Para. 2, 12)

A1. The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance processes, risk management and internal control such as the following:

Activities Relating to Governance

- The internal audit function may assess the governance process in its accomplishment of objectives on ethics and values, performance management and accountability, communicating risk and control information to appropriate areas of the organization and effectiveness of communication among those charged with governance, external and internal auditors, and management.

Activities Relating to Risk Management

- The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).

- The internal audit function may perform procedures to assist the entity in the detection of fraud.

Activities Relating to Internal Control

- Evaluation of internal control. The internal audit function may be assigned specific responsibility for reviewing controls, evaluating their operation and recommending improvements thereto. In doing so, the internal audit function provides assurance on the control. For example, the internal audit function might plan and perform tests or other procedures to provide assurance to management and those charged with governance regarding the design, implementation and operating effectiveness of internal control, including those controls that are relevant to the audit.

- Examination of financial and operating information. The internal audit function may be assigned to review the means used to identify, recognize, measure, classify and report financial and operating information, and to make specific inquiry into individual items, including detailed testing of transactions, balances and procedures.

- Review of operating activities. The internal audit function may be assigned to review the economy, efficiency and effectiveness of operating activities, including non-financial activities of an entity.

- Review of compliance with laws and regulations. The internal audit function may be assigned to review compliance with laws, regulations and other external requirements, and with management policies and directives and other internal requirements.

A2. Activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity. Some or all of the activities of an internal audit function may also be outsourced to a third-party service provider. Neither the title of the function, nor whether it is performed by the entity or a third-party service provider, are sole determinants of whether or not the external auditor can use the work of the function. Rather, it is the nature of the activities; the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; competence; and systematic and disciplined approach of the function that are relevant. References in this HKSA to the work of the internal audit function include relevant activities of other functions or third-party providers that have these characteristics.

A3. In addition, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this HKSA, although they may perform control activities that can be tested in accordance with HKSA 330.[9] For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

A4. While the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, HKSA 315 (Revised)[10] requires the external auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function); or

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9 See paragraph 8.
10 HKSA 315 (Revised), paragraph 6(a)

- Unless prohibited, or restricted to some extent, by law or regulation, the external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period in partial substitution for audit evidence to be obtained directly by the external auditor.[11]

Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used

Evaluating the Internal Audit Function

Objectivity and Competence (Ref: Para. 13(a)–(b))

A5. The external auditor exercises professional judgment in determining whether the work of the internal audit function can be used for purposes of the audit, and the nature and extent to which the work of the internal audit function can be used in the circumstances.

A6. The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

A7. Objectivity refers to the ability to perform those tasks without allowing bias, conflict of interest or undue influence of others to override professional judgments. Factors that may affect the external auditor's evaluation include the following:

- Whether the organizational status of the internal audit function, including the function's authority and accountability, supports the ability of the function to be free from bias, conflict of interest or undue influence of others to override professional judgments. For example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.

- Whether the internal audit function is free of any conflicting responsibilities, for example, having managerial or operational duties or responsibilities that are outside of the internal audit function.

- Whether those charged with governance oversee employment decisions related to the internal audit function, for example, determining the appropriate remuneration policy.

- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance, for example, in communicating the internal audit function's findings to the external auditor.

- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity, or whether their internal policies achieve the same objectives.

A8. Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination include the following:

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.

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[11] See paragraphs 13–23.

- Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.

- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.

- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.

- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards including continuing professional development requirements.

A9. Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

Application of a Systematic and Disciplined Approach (Ref: Para. 13(c))

A10. The application of a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities distinguishes the activities of the internal audit function from other monitoring control activities that may be performed within the entity.

A11. Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting, the nature and extent of which is commensurate with the size and circumstances of an entity.

- Whether the internal audit function has appropriate quality control policies and procedures, for example, such as those policies and procedures in HKSQC 1[12] that would be applicable to an internal audit function (such as those relating to leadership, human resources and engagement performance) or quality control requirements in standards set by the relevant professional bodies for internal auditors. Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

Circumstances When Work of the Internal Audit Function Cannot Be Used (Ref: Para. 14)

A12. The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a

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[12] Hong Kong Standard on Quality Control (HKSQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence.

A13. Consideration of the factors in paragraphs A7, A8 and A11 of this HKSA individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function’s organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function’s objectivity unless other factors such as those described in paragraph A7 of this HKSA collectively provide sufficient safeguards to reduce the threat to an acceptable level.

A14. In addition, the Code[13] states that a self-review threat is created when the external auditor accepts an engagement to provide internal audit services to an audit client, and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. The Code[14] discusses the prohibitions that apply in certain circumstances and the threats and the safeguards that can be applied to reduce the threats to an acceptable level in other circumstances.

Determining the Nature and Extent of Work of the Internal Audit Function that Can Be Used

Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function that Can Be Used (Ref: Para. 15–17)

A15. Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with HKSA 300.[15]

A16. Examples of work of the internal audit function that can be used by the external auditor include the following:

- Testing of the operating effectiveness of controls.
- Substantive procedures involving limited judgment.
- Observations of inventory counts.
- Tracing transactions through the information system relevant to financial reporting.
- Testing of compliance with regulatory requirements.
- In some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group (where this does not conflict with the requirements of HKSA 600).[16]

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13 The HKICPA's *Code of Ethics for Professional Accountants* (the Code), Section 290.199

14 The Code, Section 290.195–290.200

15 HKSA 300, *Planning an Audit of Financial Statements*

16 HKSA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

A17. The external auditor's determination of the planned nature and extent of use of the work of the internal audit function will be influenced by the external auditor's evaluation of the extent to which the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph 16 of this HKSA. In addition, the amount of judgment needed in planning, performing and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor's determination. Further, there are circumstances in which the external auditor cannot use the work of the internal audit function for purpose of the audit as described in paragraph 14 of this HKSA.

Judgments in planning and performing audit procedures and evaluating results (Ref: Para. 16(a))

A18. The greater the judgment needed to be exercised in planning and performing the audit procedures and evaluating the audit evidence, the external auditor will need to perform more procedures directly in accordance with paragraph 16 of this HKSA, because using the work of the internal audit function alone will not provide the external auditor with sufficient appropriate audit evidence.

A19. Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor needs to make the significant judgments in the audit engagement in accordance with paragraph 16. Significant judgments include the following:

- Assessing the risks of material misstatement;
- Evaluating the sufficiency of tests performed;
- Evaluating the appropriateness of management's use of the going concern assumption;
- Evaluating significant accounting estimates; and
- Evaluating the adequacy of disclosures in the financial statements, and other matters affecting the auditor's report.

Assessed risk of material misstatement (Ref: Para. 16(b))

A20. For a particular account balance, class of transaction or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly in accordance with paragraph 16 of this HKSA, and accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in HKSA 200,[17] the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the external auditor will need to perform more of the work directly.

A21. As explained in HKSA 315 (Revised),[18] significant risks require special audit consideration and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, where the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

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[17] HKSA 200, paragraph A29

[18] HKSA 315 (Revised), paragraph 4(e)

A22. Carrying out procedures in accordance with this HKSA may cause the external auditor to reevaluate the external auditor's assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether to use the work of the internal audit function and whether further application of this HKSA is necessary.

Communication with Those Charged with Governance (Ref: Para. 18)

A23. In accordance with HKSA 260,[19] the external auditor is required to communicate with those charged with governance an overview of the planned scope and timing of the audit. The planned use of the work of the internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

Using the Work of the Internal Audit Function

Discussion and Coordination with the Internal Audit Function (Ref: Para. 19)

A24. In discussing the planned use of their work with the internal audit function as a basis for coordinating the respective activities, it may be useful to address the following:

- The timing of such work.
- The nature of the work performed.
- The extent of audit coverage.
- Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
- Proposed methods of item selection and sample sizes.
- Documentation of the work performed.
- Review and reporting procedures.

A25. Coordination between the external auditor and the internal audit function is effective when, for example:

- Discussions take place at appropriate intervals throughout the period.
- The external auditor informs the internal audit function of significant matters that may affect the function.
- The external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

19 HKSA 260, paragraph 15

A26. HKSA 200[20] discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.[21] The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with HKSA 240.[22]

Procedures to Determine the Adequacy of Work of the Internal Audit Function (Ref: Para. 21–22)

A27. The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating the overall quality of the function's work and the objectivity with which it has been performed.

A28. The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 22, include the following:

- Making inquiries of appropriate individuals within the internal audit function.
- Observing procedures performed by the internal audit function.
- Reviewing the internal audit function's work program and working papers.

A29. The more judgment involved, the higher the assessed risk of material misstatement, the less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

Reperformance (Ref: Para. 22)

A30. For purposes of this HKSA, reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function, or where it is not possible to do so, the same objective may also be accomplished by examining sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform in paragraph A28. While it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor plans to use in accordance with paragraph 22. The external auditor is more likely to focus reperformance in those areas where more judgment was exercised by the internal audit function in planning, performing and evaluating the results of the audit procedures and in areas of higher risk of material misstatement.

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20 HKSA 200, paragraphs 15 and A18

21 HKSA 315 (Revised), paragraph A116

22 HKSA 315 (Revised), paragraph A11 in relation to HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

CONFORMING AMENDMENTS TO OTHER HKSAs

HKSA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing

A72. In some cases, a HKSA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in HKSA 610 (Revised)[1] is relevant.

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HKSA 230, Audit Documentation

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant[2] only in the cases where:

(a) The entire HKSA is not relevant (for example, if an entity does not have an internal audit function, nothing in HKSA 610 (Revised)[3] is relevant); or

(b) The requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion where there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

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HKSA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

19. For those entities that have an internal audit function, the auditor shall make inquiries of appropriate individuals within the function ~~internal audit~~ to determine whether ~~it~~ they haves ~~s~~ knowledge of any actual, suspected or alleged fraud affecting the entity, and to obtain its views about the risks of fraud. (Ref: Para. A18)

Inquiries~~y~~ of the Internal Audit Function (Ref: Para. 19)

A18. HKSA 315 (Revised) and HKSA 610 (Revised) establish requirements and provide guidance relevant to ~~in~~ audits of those entities that have an internal audit function.[4] In carrying out the requirements of those HKSAs in the context of fraud, the auditor may inquire about specific activities of the function ~~internal audit activities~~ including, for example:

- The procedures performed, if any, by the internal audit~~ors~~ function during the year to detect fraud.

- Whether management has satisfactorily responded to any findings resulting from those procedures.

[1] HKSA 610 (Revised), *Using the Work of Internal Auditors*, paragraph 2

[2] HKSA 200, paragraph 22

[3] HKSA 610 (Revised), *Using the Work of Internal Auditors*, paragraph 2

[4] HKSA 315 (Revised), paragraphs 6(a) and 23, and HKSA 610 (Revised), *Using the Work of Internal Auditors*

Appendix 1

Examples of Fraud Risk Factors

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).

- High turnover rates or employment of staff in accounting, ~~internal audit, or~~ information technology, or the internal audit function ~~staff~~ that are not effective.

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HKSA 260, Communication with Those Charged with Governance

A14. Other planning matters that it may be appropriate to discuss with those charged with governance include:

- Where the entity has an internal audit function, ~~the extent to which~~ how the external auditor ~~will use the work of internal audit, and how the external~~ and internal auditors can ~~best~~ work ~~together~~ in a constructive and complementary manner, including any planned use of the work of the internal audit function.[5]

- …

A33. Before communicating matters with those charged with governance, the auditor may discuss them with management, unless that is inappropriate. For example, it may not be appropriate to discuss questions of management's competence or integrity with management. In addition to recognizing management's executive responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with ~~the~~ appropriate individuals within the function ~~internal auditor~~ before communicating with those charged with governance.

A43. As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, HKSA 315 (Revised) identifies participation by those charged with governance, including their interaction with the internal audit function, if any, and external auditors, as an element of the entity's control environment.[6] Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

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[5] HKSA 610 (Revised), paragraph 18

[6] HKSA 315 (Revised), paragraph A77~~70~~

HKSA 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

A24. If the auditor has communicated deficiencies in internal control other than significant deficiencies to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor is also not required to repeat information about such deficiencies if it has been previously communicated to management by other parties, such as the internal audit~~ors~~ function or regulators. It may, however, be appropriate for the auditor to re-communicate these other deficiencies if there has been a change of management, or if new information has come to the auditor's attention that alters the prior understanding of the auditor and management regarding the deficiencies. …

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HKSA 300, Planning an Audit of Financial Statements

Appendix

Characteristics of the Engagement

…

- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.

- ~~The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work~~Whether the entity has an internal audit function and if so, whether, in which areas and to what extent, the work of the function can be used for purposes of the audit.

…

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HKSA 402, Audit Considerations Relating to an Entity Using a Service Organization

A1. Information on the nature of the services provided by a service organization may be available from a wide variety of sources, such as:

- User manuals.

- System overviews.

- Technical manuals.

- The contract or service level agreement between the user entity and the service organization.

- Reports by service organizations, the internal audit~~ors~~ function or regulatory authorities on controls at the service organization.

- Reports by the service auditor, including management letters, if available.

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HKSA 500, Audit Evidence

A51. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities**,** such as ~~internal auditor's~~ reports of the internal audit function. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

Inconsistency in, or Doubts over Reliability of, Audit Evidence (Ref: Para. 11)

A57. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal auditors, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. HKSA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.[7]

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HKSA 550, Related Parties

A15. Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions, and the entity's controls over such relationships and transactions. These may include, to the extent that they do not form part of management:

- Those charged with governance;
- Personnel in a position to initiate, process, or record transactions that are both significant and outside the entity's normal course of business, and those who supervise or monitor such personnel;
- The ~~I~~internal audit~~ors~~ function;
- In-house legal counsel; and
- The chief ethics officer or equivalent person.

A17. In meeting the HKSA 315 (Revised) requirement to obtain an understanding of the control environment,[8] the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as:

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions.

…

- Periodic reviews by the internal audit~~ors~~ function, where applicable.

[7] HKSA 230, *Audit Documentation*, paragraph 11

[8] HKSA 315 (Revised), paragraph 14

…

A22. During the audit, the auditor may inspect records or documents that may provide information about related party relationships and transactions, for example:

- Third-party confirmations obtained by the auditor (in addition to bank and legal confirmations).

…

- ~~Internal auditors' r~~Reports of the internal audit function.

…

***

HKSA 600, Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)

A27. The auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud, and to design and implement appropriate responses to the assessed risks.[9] Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following:

- ...
- Responses of those charged with governance of the group, group management, appropriate individuals within the internal audit function (and if considered appropriate, component management, the component auditors, and others) to the group engagement team's *inquiry* whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.
- …

A51. The group engagement team's decision as to how many components to select in accordance with paragraph 29, which components to select, and the type of work to be performed on the financial information of the individual components selected may be affected by factors such as the following:

- …
- Whether the internal audit function has performed work at the component and any effect of that work on the group audit.
- …

[9] HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

Appendix 2

Examples of Matters about Which the Group Engagement Team Obtains an Understanding

The examples provided cover a broad range of matters; however, not all matters are relevant to every group audit engagement and the list of examples is not necessarily complete.

Group-Wide Controls

1. Group-wide controls may include a combination of the following:

    - …
    - Monitoring of controls, including activities of the internal audit function and self-assessment programs.
    - …

2. The ~~I~~internal audit function may be regarded as part of group-wide controls, for example, when the ~~internal audit~~ function is centralized. HKSA 610 (Revised)[10] deals with the group engagement team's evaluation of ~~the~~ whether the internal audit function's organizational status and relevant policies and procedures adequately supports the ~~competence and~~objectivity of ~~the~~ internal auditors, the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach where the group engagement team expects ~~it plans~~ to use ~~their~~ the function's work.

Appendix 5

Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction

Matters that are relevant to the conduct of the work of the component auditor:

- …
- The findings of the internal audit function, based on work performed on controls at or relevant to components

[10] HKSA 610, *Using the Work of Internal Auditors*, paragraphs 16-17~~19~~

HKSRS 4410
Issued November 2004; revised July 2012

Effective upon issue*

Hong Kong Standard on Related Services 4410

Engagements to Compile Financial Statements

* HKSRS 4410 is applicable for compilation engagement reports dated before 1 July 2013. HKSRS 4410 (Revised) "Compilation Engagements" is applicable for compilation engagement reports dated on or after 1 July 2013.

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

HKSRS 4410 (Revised)
Revised July 2012

Effective for compilation engagement reports dated on or after 1 July 2013

Hong Kong Standard on Related Services 4410 (Revised)

Compilation Engagements

Hong Kong Institute of
Certified Public Accountants
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HONG KONG STANDARD ON RELATED SERVICES 4410 (REVISED)

COMPILATION ENGAGEMENTS

(Effective for compilation engagement reports dated on or after 1 July 2013)

CONTENTS

Hong Kong Standard on Related Services (HKSRS) 4410 (Revised), *Compilation Engagements*, should be read in conjunction with the *Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*.

Introduction

Scope of this HKSRS

1. This Hong Kong Standard on Related Services (HKSRS) deals with the practitioner's responsibilities when engaged to assist management with the preparation and presentation of historical financial information without obtaining any assurance on that information, and to report on the engagement in accordance with this HKSRS. (Ref: Para. A1–A2)

2. This HKSRS applies to compilation engagements for historical financial information. The HKSRS may be applied, adapted as necessary, to compilation engagements for financial information other than historical financial information, and to compilation engagements for non-financial information. Hereinafter in this HKSRS, reference to "financial information" means "historical financial information." (Ref: Para. A3–A4)

3. When the practitioner is requested to assist management with the preparation and presentation of financial information, appropriate consideration may need to be given to whether the engagement should be undertaken in accordance with this HKSRS. Factors that indicate that it may be appropriate to apply this HKSRS, including reporting under this HKSRS, include whether:

   - The financial information is required under provisions of applicable law or regulation, and whether it is required to be publicly filed.

   - External parties other than the intended users of the compiled financial information are likely to associate the practitioner with the financial information, and there is a risk that the level of the practitioner's involvement with the information may be misunderstood, for example:

     If the financial information is intended for use by parties other than management or those charged with governance, or may be provided to, or obtained by, parties who are not the intended users of the information; and

     If the practitioner's name is identified with the financial information. (Ref: Para. A5)

Relationship with HKSQC 1[1]

4. Quality control systems, policies and procedures are the responsibility of the firm. HKSQC 1 applies to firms of professional accountants in respect of a firm's compilation engagements.[2] The provisions of this HKSRS regarding quality control at the level of individual compilation engagements are premised on the basis that the firm is subject to HKSQC 1 or requirements that are at least as demanding. (Ref: Para. A6–A11)

The Compilation Engagement

5. Management may request a professional accountant in public practice to assist with the preparation and presentation of financial information of an entity. The value of a compilation engagement performed in accordance with this HKSRS to users of financial information results from the application of the practitioner's professional expertise in accounting and financial reporting and compliance with professional standards, including relevant ethical requirements, and the clear communication of the nature and extent of the practitioner's involvement with the compiled financial information. (Ref: Para. A12–A15)

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[1] Hong Kong Standard on Quality Control (HKSQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

[2] HKSQC 1, paragraph 4

6. Since a compilation engagement is not an assurance engagement, a compilation engagement does not require the practitioner to verify the accuracy or completeness of the information provided by management for the compilation, or otherwise to gather evidence to express an audit opinion or a review conclusion on the preparation of the financial information.

7. Management retains responsibility for the financial information and the basis on which it is prepared and presented. That responsibility includes application by management of the judgment required for the preparation and presentation of the financial information, including the selection and application of appropriate accounting policies and, where needed, developing reasonable accounting estimates. (Ref: Para. A12–A13)

8. This HKSRS does not impose responsibilities on management or those charged with governance, or override laws and regulations that govern their responsibilities. An engagement performed in accordance with this HKSRS is conducted on the premise that management, or those charged with governance where appropriate, have agreed certain responsibilities that are fundamental to the performance of the compilation engagement. (Ref: Para. A12–A13)

9. Financial information that is the subject of a compilation engagement may be required for various purposes including:

   (a) To comply with mandatory periodic financial reporting requirements established in law or regulation; or

   (b) For purposes unrelated to mandatory financial reporting under relevant law or regulation, including for example:

      - For management or those charged with governance, prepared on a basis appropriate for their particular purposes (such as preparation of financial information for internal use).

      - For periodic financial reporting undertaken for external parties under a contract or other form of agreement (such as financial information provided to a funding body to support provision or continuation of a grant).

      - For transactional purposes, for example to support a transaction involving changes to the entity's ownership or financing structure (such as for a merger or acquisition).

10. Different financial reporting frameworks can be used to prepare and present financial information, ranging from a simple entity-specific basis of accounting to established financial reporting standards. The financial reporting framework adopted by management to prepare and present the financial information will depend on the nature of the entity and the intended use of the information. (Ref: Para. A16–A18)

Authority of this HKSRS

11. This HKSRS contains the objectives of the practitioner in following the HKSRS which provide the context in which the requirements of this HKSRS are set, and are intended to assist the practitioner in understanding what needs to be accomplished in a compilation engagement.

12. This HKSRS contains requirements, expressed using "shall," that are designed to enable the practitioner to meet the stated objectives.

13. In addition, this HKSRS contains introductory material, definitions, and application and other explanatory material, that provide context relevant to a proper understanding of the HKSRS.

14. The application and other explanatory material provides further explanation of the requirements and guidance for carrying them out. While such guidance does not in itself

impose a requirement, it is relevant to the proper application of the requirements. The application and other explanatory material may also provide background information on matters addressed in this HKSRS that assists in the application of the requirements.

Effective Date

15. This HKSRS is effective for compilation engagement reports dated on or after 1 July 2013.

Objectives

16. The practitioner's objectives in a compilation engagement under this HKSRS are to:

    (a) Apply accounting and financial reporting expertise to assist management in the preparation and presentation of financial information in accordance with an applicable financial reporting framework based on information provided by management; and

    (b) Report in accordance with the requirements of this HKSRS.

Definitions

17. The Members' Handbook's Glossary of Terms[3] (the Glossary) includes the terms defined in this HKSRS and also includes descriptions of other terms found in this HKSRS, to assist in consistent interpretation. The following terms have the meanings attributed below for the purposes of this HKSRS:

    (a) *Applicable financial reporting framework* – The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial information that is acceptable in view of the nature of the entity and the objective of the financial information, or that is required by law or regulation. (Ref: Para. A30–A32)

    (b) *Compilation engagement* – An engagement in which a practitioner applies accounting and financial reporting expertise to assist management in the preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework, and reports as required by this HKSRS. Throughout this HKSRS, the words "compile", "compiling" and "compiled" are used in this context.

    (c) *Engagement partner* – The partner or other person in the firm who is responsible for the engagement and its performance, and for the report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

    (d) *Engagement team* – All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes external experts engaged by the firm or a network firm.

    (e) *Misstatement* – A difference between the amount, classification, presentation, or disclosure of a reported item in the financial information, and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

    Where the financial information is prepared in accordance with a fair presentation framework, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the practitioner's judgment, are necessary for the

[3] The Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services issued by the HKICPA in Volume III of the Members' Handbook

financial information to be presented fairly, in all material respects, or to give a true and fair view.

(f) *Practitioner* – A professional accountant in public practice who conducts the compilation engagement. The term includes the engagement partner or other members of the engagement team, or, as applicable, the firm. Where this HKSRS expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "practitioner" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.

(g) *Relevant ethical requirements* – Ethical requirements the engagement team is subject to when undertaking compilation engagements. These requirements ordinarily comprise Parts A, B and D of the HKICPA's *Code of Ethics for Professional Accountants* (the Code) (excluding Section 290*, Independence—Audit and Review Engagements*, and Section 291, *Independence—Other Assurance Engagements* in Part B), together with local requirements that are more restrictive. (Ref: Para. A21)

Requirements

Conduct of a Compilation Engagement in Accordance with this HKSRS

18. The practitioner shall have an understanding of the entire text of this HKSRS, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

Complying with Relevant Requirements

19. The practitioner shall comply with each requirement of this HKSRS unless a particular requirement is not relevant to the compilation engagement, for example if the circumstances addressed by the requirement do not exist in the engagement.

20. The practitioner shall not represent compliance with this HKSRS unless the practitioner has complied with all requirements of this HKSRS relevant to the compilation engagement.

Ethical Requirements

21. The practitioner shall comply with relevant ethical requirements. (Ref: Para. A19–A21)

Professional Judgment

22. The practitioner shall exercise professional judgment in conducting a compilation engagement. (Ref: Para. A22–A24)

Engagement Level Quality Control

23. The engagement partner shall take responsibility for:

(a) The overall quality of each compilation engagement to which that partner is assigned; and

(b) The engagement being performed in accordance with the firm's quality control policies and procedures, by: (Ref: Para. A25)

(i) Following appropriate procedures regarding the acceptance and continuance of client relationships and engagements; (Ref: Para. A26)

(ii) Being satisfied that the engagement team collectively has the appropriate competence and capabilities to perform the compilation engagement;

(iii) Being alert for indications of non-compliance by members of the engagement team with relevant ethical requirements, and determining the appropriate action if matters come to the engagement partner's attention indicating that members of the engagement team have not complied with relevant ethical requirements; (Ref: Para. A27)

(iv) Directing, supervising and performing the engagement in compliance with professional standards and applicable legal and regulatory requirements; and

(v) Taking responsibility for appropriate engagement documentation being maintained.

Engagement Acceptance and Continuance

Continuance of Client Relationships, Engagement Acceptance and Agreeing the Terms of the Engagement

24. The practitioner shall not accept the engagement unless the practitioner has agreed the terms of engagement with management, and the engaging party if different, including:

(a) The intended use and distribution of the financial information, and any restrictions on either its use or its distribution where applicable; (Ref: Para. A20, A28–A29, A32–A33)

(b) Identification of the applicable financial reporting framework; (Ref: Para. A20, A30–A33)

(c) The objective and scope of the compilation engagement; (Ref: Para. A20)

(d) The responsibilities of the practitioner, including the requirement to comply with relevant ethical requirements; (Ref: Para. A20)

(e) The responsibilities of management for: (Ref: Para. A34–A36)

(i) The financial information, and for the preparation and presentation thereof, in accordance with a financial reporting framework that is acceptable in view of the intended use of the financial information and the intended users;

(ii) The accuracy and completeness of the records, documents, explanations and other information provided by management for the compilation engagement; and

(iii) Judgments needed in the preparation and presentation of the financial information, including those for which the practitioner may provide assistance in the course of the compilation engagement; and (Ref: Para. A22)

(f) The expected form and content of the practitioner's report.

25. The practitioner shall record the agreed terms of engagement in an engagement letter or other suitable form of written agreement, prior to performing the engagement. (Ref: Para. A37–A39)

Recurring Engagements

26. On recurring compilation engagements, the practitioner shall evaluate whether circumstances, including changes in the engagement acceptance considerations, require the terms of engagement to be revised and whether there is need to remind management of the existing terms of engagement. (Ref: Para. A40)

Communication with Management and Those Charged with Governance

27. The practitioner shall communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the compilation engagement, all matters concerning the compilation engagement that, in the practitioner's professional judgment, are of sufficient importance to merit the attention of management or those charged with governance, as appropriate. (Ref: Para. A41)

Performing the Engagement

The Practitioner's Understanding

28. The practitioner shall obtain an understanding of the following matters sufficient to be able to perform the compilation engagement: (Ref: Para. A42–A44)

    (a) The entity's business and operations, including the entity's accounting system and accounting records; and

    (b) The applicable financial reporting framework, including its application in the entity's industry.

Compiling the Financial Information

29. The practitioner shall compile the financial information using the records, documents, explanations and other information, including significant judgments, provided by management.

30. The practitioner shall discuss with management, or those charged with governance as appropriate, those significant judgments, for which the practitioner has provided assistance in the course of compiling the financial information. (Ref: Para. A45)

31. Prior to completion of the compilation engagement, the practitioner shall read the compiled financial information in light of the practitioner's understanding of the entity's business and operations, and of the applicable financial reporting framework. (Ref: Para. A46)

32. If, in the course of the compilation engagement, the practitioner becomes aware that the records, documents, explanations or other information, including significant judgments, provided by management for the compilation engagement are incomplete, inaccurate or otherwise unsatisfactory, the practitioner shall bring that to the attention of management and request the additional or corrected information.

33. If the practitioner is unable to complete the engagement because management has failed to provide records, documents, explanations or other information, including significant judgments, as requested, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing. (Ref: Para. A52)

34. If the practitioner becomes aware during the course of the engagement that:

    (a) The compiled financial information does not adequately refer to or describe the applicable financial reporting framework; (Ref: Para. A47)

    (b) Amendments to the compiled financial information are required for the financial information not to be materially misstated; or (Ref: Para. A48–A50)

    (c) The compiled financial information is otherwise misleading, (Ref: Para. A51)

    the practitioner shall propose the appropriate amendments to management.

35. If management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall withdraw from the engagement and inform management and those charged with governance of the reasons for withdrawing. (Ref: Para. A52)

36. If withdrawal from the engagement is not possible, the practitioner shall determine the professional and legal responsibilities applicable in the circumstances.

37. The practitioner shall obtain an acknowledgement from management or those charged with governance, as appropriate, that they have taken responsibility for the final version of the compiled financial information. (Ref: Para. A62)

Documentation

38. The practitioner shall include in the engagement documentation: (Ref: Para. A53–A55)

    (a) Significant matters arising during the compilation engagement and how those matters were addressed by the practitioner;

    (b) A record of how the compiled financial information reconciles with the underlying records, documents, explanations and other information, provided by management; and

    (c) A copy of the final version of the compiled financial information for which management or those charged with governance, as appropriate, has acknowledged their responsibility, and the practitioner's report. (Ref: Para. A62)

The Practitioner's Report

39. An important purpose of the practitioner's report is to clearly communicate the nature of the compilation engagement, and the practitioner's role and responsibilities in the engagement. The practitioner's report is not a vehicle to express an opinion or conclusion on the financial information in any form.

40. The practitioner's report issued for the compilation engagement shall be in writing, and shall include the following elements: (Ref: Para. A56–A57, A63)

    (a) The report title;

    (b) The addressee(s), as required by the terms of the engagement; (Ref: Para. A58)

    (c) A statement that the practitioner has compiled the financial information based on information provided by management;

    (d) A description of the responsibilities of management, or those charged with governance as appropriate, in relation to the compilation engagement, and in relation to the financial information;

(e) Identification of the applicable financial reporting framework and, if a special purpose financial reporting framework is used, a description or reference to the description of that special purpose financial reporting framework in the financial information;

(f) Identification of the financial information, including the title of each element of the financial information if it comprises more than one element, and the date of the financial information or the period to which it relates;

(g) A description of the practitioner's responsibilities in compiling the financial information, including that the engagement was performed in accordance with this HKSRS, and that the practitioner has complied with relevant ethical requirements;

(h) A description of what a compilation engagement entails in accordance with this HKSRS;

(i) Explanations that:

  (i) Since a compilation engagement is not an assurance engagement, the practitioner is not required to verify the accuracy or completeness of the information provided by management for the compilation,; and

  (ii) Accordingly, the practitioner does not express an audit opinion or a review conclusion on whether the financial information is prepared in accordance with the applicable financial reporting framework.

(j) If the financial information is prepared using a special purpose financial reporting framework, an explanatory paragraph that: (Ref: Para. A59–A61)

  (i) Describes the purpose for which the financial information is prepared and, if necessary, the intended users, or contains a reference to a note in the financial information that discloses this information; and

  (ii) Draws the attention of readers of the report to the fact that the financial information is prepared in accordance with a special purpose framework and that, as a result, the information may not be suitable for other purposes;

(k) The date of the practitioner's report;

(l) The practitioner's signature; and

(m) The practitioner's address.

41. The practitioner shall date the report on the date the practitioner has completed the compilation engagement in accordance with this HKSRS. (Ref: Para. A62)

Conformity and Compliance with International Standards on Related Services

42. As of July 2012 *(date of issue)*, this HKSRS conforms with International Standard on Related Services (ISRS) 4410 (Revised), "Compilation Engagements" except that references to IFAC Code of Ethics for Professional Accountants are replaced by HKICPA's Code of Ethics for Professional Accountants. With the exception of the foregoing difference, compliance with the requirements of this HKSRS ensures compliance with ISRS 4410 (Revised).

43. Additional local guidance is provided in footnote 6a of Appendix 1 and footnotes 6b, 6c, 7a, 7b and 8a of Appendix 2.

***

Application and Other Explanatory Material

Scope of this HKSRS

General Considerations (Ref: Para. 1)

A1. In a compilation engagement where the engaging party is someone other than management or those charged with governance of the entity, this HKSRS may be applied adapted as necessary.

A2. A practitioner's involvement with services or activities in the course of assisting management of an entity with the preparation and presentation of the entity's financial information can take many different forms. When the practitioner is engaged to provide such services or activities for an entity under this HKSRS, the practitioner's association with the financial information is communicated through the practitioner's report provided for the engagement in the form required by this HKSRS. The practitioner's report contains the practitioner's explicit assertion of compliance with this HKSRS.

Application to Compilation Engagements Other than for Historical Financial Information (Ref: Para. 2)

A3. This HKSRS addresses engagements where the practitioner assists management in the preparation and presentation of historical financial information. The HKSRS may, however, also be applied, adapted as necessary, when the practitioner is engaged to assist management in preparing and presenting other financial information. Examples include:

- Pro forma financial information.
- Prospective financial information, including financial budgets or forecasts.

A4. Practitioners may also undertake engagements to assist management in the preparation and presentation of non-financial information, for example, greenhouse gas statements, statistical returns or other information returns. In those circumstances, the practitioner may apply this HKSRS, adapted as necessary, as relevant to those types of engagements.

Considerations Relevant to Application of the HKSRS (Ref: Para. 3)

A5. Mandatory application of this HKSRS may be specified in local settings for engagements where practitioners undertake services relevant to the preparation and presentation of financial information of an entity (such as in relation to preparation of historical financial statements required for public filing). If mandatory application is not specified, either under law or regulation, or under applicable professional standards or otherwise, the practitioner may nevertheless conclude that applying this HKSRS is appropriate in the circumstances.

Relationship with HKSQC 1 (Ref: Para. 4)

A6. HKSQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for related services engagements, including compilation engagements. Those responsibilities are directed at establishing:

- The firm's quality control system; and
- The firm's related policies designed to achieve the objective of the quality control system and its procedures to implement and monitor compliance with those policies.

A7. Under HKSQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

(a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

(b) Reports issued by the firm or engagement partners are appropriate in the circumstances.[4]

A8. A jurisdiction that has not adopted HKSQC 1 in relation to compilation engagements may set out requirements for quality control in firms performing such engagements. The provisions of this HKSRS regarding quality control at the engagement level are premised on the basis that quality control requirements adopted are at least as demanding as those of HKSQC 1. This is achieved when those requirements impose obligations on the firm to achieve the aims of the requirements of HKSQC 1, including an obligation to establish a system of quality control that includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

A9. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures applicable to the engagement.

A10. Unless information provided by the firm or other parties suggests otherwise, the engagement team is entitled to rely on the firm's system of quality control. For example, the engagement team may rely on the firm's system of quality control in relation to:

- Competence of personnel through their recruitment and formal training.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to legal and regulatory requirements through the monitoring process.

In considering deficiencies identified in the firm's system of quality control that may affect the compilation engagement, the engagement partner may consider measures taken by the firm to rectify the situation that the engagement partner considers are sufficient in the context of that compilation engagement.

A11. A deficiency in the firm's system of quality control does not necessarily indicate that a compilation engagement was not performed in accordance with professional standards and applicable legal and regulatory requirements, or that the practitioner's report was not appropriate.

[4] HKSQC 1, paragraph 11

The Compilation Engagement

Use of the Terms "Management" and "Those Charged with Governance" (Ref: Para. 5, 7–8)

A12. The respective responsibilities of management and those charged with governance will differ between jurisdictions, and between entities of various types. These differences affect the way the practitioner applies the requirements of this HKSRS regarding management or those charged with governance. Accordingly, the phrase "management and, where appropriate, those charged with governance" used in various places throughout this HKSRS is intended to alert the practitioner to the fact that different entity environments may have different management and governance structures and arrangements.

A13. Various responsibilities relating to the preparation of financial information and external financial reporting fall to either management or those charged with governance according to factors such as:

- The resources and structure of the entity.
- The respective roles of management and those charged with governance within the entity as set out in relevant law or regulation or, if the entity is not regulated, in any formal governance or accountability arrangements established for the entity (for example, as recorded in contracts, or a constitution or other type of document by which an entity is established).

In many small entities, there is often no separation of the management and governance roles for the entity, or those charged with governance of the entity may also be involved in managing the entity. In most other cases, especially in larger entities, management is responsible for execution of the business or activities of the entity and reporting thereon, while those charged with governance have oversight of management. In larger entities, those charged with governance will often have or assume responsibility for approving the financial information of the entity, particularly when it is intended for use by external parties. In large entities, often a subgroup of those charged with governance, such as an audit committee, is charged with certain oversight responsibilities. In some jurisdictions, the preparation of financial statements for an entity in accordance with a specified framework is the legal responsibility of those charged with governance, and in other jurisdictions it is a management responsibility.

Involvement in Other Activities Relating to Preparation and Presentation of Financial Information (Ref: Para. 5)

A14. The scope of a compilation engagement will vary depending on the circumstances of the engagement. However, in every case it will involve assisting management in the preparation and presentation of the entity's financial information in accordance with the financial reporting framework, based on information provided by management. In some compilation engagements, management may have already prepared the financial information itself in a draft or preliminary form.

A15. A practitioner may also be engaged to undertake certain other activities on behalf of management, additional to the compilation engagement. For example, the practitioner may be requested to also collect, classify and summarize the underlying accounting data of the entity and process the data in the form of accounting records through to production of a trial balance. The trial balance would then be used as the underlying information from which the practitioner can compile the financial information that is the subject of a compilation engagement undertaken in accordance with this HKSRS. This is often the case for smaller entities that do not have well-developed accounting systems, or entities that prefer to outsource the preparation of accounting records to external providers. This HKSRS does not address such additional activities that the practitioner may perform to assist management in other areas, in advance of compiling the entity's financial statements.

Financial Reporting Frameworks (Ref: Para. 10)

A16. The financial information may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (that is, a "general purpose financial reporting framework"); or
- The financial information needs of specific users (that is, a "special purpose financial reporting framework").

The requirements of the applicable financial reporting framework determine the form and content of the financial information. The financial reporting framework may, in some cases, be referred to as the "basis of accounting."

A17. Examples of commonly used general purpose financial reporting frameworks are:

- Hong Kong Financial Reporting Standards (HKFRS).
- International Financial Reporting Standards (IFRS).
- Hong Kong Financial Reporting Standards for Private Entities (HKFRS-PE).
- Hong Kong Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard (SME-FRF & SME-FRS).
- International Financial Reporting Standards for Small- and Medium-Sized Entities (IFRS for SMEs).

A18. Examples of special purpose financial reporting frameworks that may be used, depending on the particular purpose of the financial information, are:

- The tax basis of accounting used in a particular jurisdiction to prepare financial information to fulfill tax compliance obligations.
- For entities not required to use an established financial reporting framework:
    - ○ A basis of accounting used in the financial information of a particular entity that is appropriate for the intended use of the financial information and the entity's circumstances (for example, use of the cash basis of accounting with selected accruals, such as accounts receivable and accounts payable, leading to a balance sheet and income statement; or use of an established financial reporting framework that is modified to suit the particular purpose for which the financial information is prepared).
    - ○ The cash basis of accounting leading to a statement of receipts and disbursements (for example, for the purpose of allocating the excess of cash receipts over disbursements to the owners of a rental property; or to record movements in the petty cash fund of a club).

Ethical Requirements (Ref: Para. 21)

A19. Part A of the Code establishes the fundamental principles of professional ethics that practitioners must comply with, and provides a conceptual framework for applying those principles. The fundamental principles are:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

Part B of the Code illustrates how the conceptual framework is to be applied in specific situations. In complying with the Code, threats to the practitioner's compliance with relevant ethical requirements are required to be identified and appropriately addressed.

Ethical Considerations Regarding the Practitioner's Association with Information (Ref: Para. 21, 24(a)–(d))

A20. Under the Code,[5] in applying the principle of integrity, a professional accountant is required to not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

When a professional accountant becomes aware that the accountant has been associated with such information, the accountant is required by the Code to take steps to be disassociated from that information.

Independence (Ref: Para. 17(g), 21)

A21. Notwithstanding that Section 290, *Independence—Audit and Review Engagements* and Section 291, *Independence—Other Assurance Engagements* in Part B of the Code do not apply to compilation engagements, local ethical codes or laws or regulations may specify requirements or disclosure rules pertaining to independence.

Professional Judgment (Ref: Para. 22, 24(e)(iii))

A22. Professional judgment is essential to the proper conduct of a compilation engagement. This is because interpretation of relevant ethical requirements and the requirements of this HKSRS, and the need for informed decisions throughout the performance of a compilation engagement, require the application of relevant knowledge and experience to the facts and circumstances of the engagement. Professional judgment is necessary, in particular, when the engagement involves assisting management of the entity regarding decisions about:

- The acceptability of the financial reporting framework that is to be used to prepare and present the financial information of the entity, in view of the intended use of the financial information and the intended users thereof.
- The application of the applicable financial reporting framework, including:
    - Selection of appropriate accounting policies under that framework;

[5] The Code Part A, paragraph 110.2

- ○ Development of accounting estimates needed for the financial information to be prepared and presented under that framework; and

- ○ Preparation and presentation of financial information in accordance with the applicable financial reporting framework.

The practitioner's assistance to management is always provided on the basis that management or those charged with governance, as appropriate, understand the significant judgments that are reflected in the financial information, and accept responsibility for those judgments.

A23. Professional judgment involves the application of relevant training, knowledge and experience, within the context provided by this HKSRS and accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the compilation engagement.

A24. The exercise of professional judgment in individual engagements is based on the facts and circumstances that are known to the practitioner up to the date of the practitioner's report on the engagement, including:

- Knowledge acquired from performance of other engagements undertaken for the entity, where applicable (for example, taxation services).

- The practitioner's understanding of the entity's business and operations, including its accounting system, and of the application of the applicable financial reporting framework in the industry in which the entity operates.

- The extent to which the preparation and presentation of the financial information requires the exercise of management judgment.

Engagement Level Quality Control (Ref: Para. 23(b))

A25. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each engagement, emphasize the importance to achieving the quality of the engagement of:

(a) Performing work that complies with professional standards and regulatory and legal requirements;

(b) Complying with the firm's quality control policies and procedures as applicable; and

(c) Issuing the practitioner's report for the engagement in accordance with this HKSRS.

Acceptance and Continuance of Client Relationships and Compilation Engagements (Ref: Para. 23(b)(i))

A26. HKSQC 1 requires the firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. Information that assists the engagement partner in determining whether acceptance or continuance of client relationships and compilation engagements is appropriate may include information concerning the integrity of the principal owners, key management and those charged with governance. If the engagement partner has cause to doubt management's integrity to a degree that is likely to affect proper performance of the engagement, it may not be appropriate to accept the engagement.

Compliance with Relevant Ethical Requirements in Conducting the Engagement (Ref: Para. 23(b)(iii))

A27. HKSQC 1 sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. This HKSRS sets out the engagement partner's responsibilities with respect to the engagement team's compliance with relevant ethical requirements.

Engagement Acceptance and Continuance

Identifying the Intended Use of the Financial Information (Ref: Para. 24(a))

A28. The intended use of the financial information is identified with reference to applicable law, regulation, or other arrangements established concerning the provision of financial information of the entity, bearing in mind the financial information needs of parties internal or external to the entity who are the intended users. Examples are financial information required to be provided by an entity in connection with undertaking transactions or financing applications with external parties such as suppliers, banks or other providers of finance or funding.

A29. The practitioner's identification of the intended use of the financial information also involves understanding such factors as the particular purpose(s) of management, or those charged with governance, where applicable, that are intended to be served through requesting the compilation engagement, and those of the engaging party where different. For example, a grant funding body may require the entity to provide financial information compiled by a professional accountant to obtain information about certain aspects of an entity's operations or activities, prepared in a specified form, to support provision of a grant or continuation of an existing grant.

Identification of the Applicable Financial Reporting Framework (Ref: Para. 17(a), 24(b))

A30. The decision about the financial reporting framework that management adopts for the financial information is made in the context of the intended use of the information as described in the agreed terms of engagement, and the requirements of any applicable law or regulation.

A31. The following are examples of factors that indicate it may be relevant to consider whether the financial reporting framework is acceptable:

- The nature of the entity, and whether it is a regulated form of entity, for example, whether it is a profit-oriented business enterprise, a public sector entity or a not-for-profit organization.
- The intended use of the financial information and the intended users. For example, the financial information could be intended to be used by a wide range of users or, alternatively, could be for use by management or by certain external users in the context of a particular purpose specified as part of agreeing the terms of the compilation engagement.
- Whether the applicable financial reporting framework is prescribed or specified, either in applicable law or regulation, or in a contract or other form of agreement with a third party, or as part of governance or accountability arrangements adopted voluntarily by the entity.
- The nature and form of the financial information that is to be prepared and presented under the applicable financial reporting framework, for example, a complete set of financial statements, a single financial statement, or financial information presented in another format agreed between parties to a contract or other form of agreement.

Relevant Factors When Financial Information Is Intended for a Particular Purpose (Ref: Para. 24(a) – (b))

A32. The engaging party generally agrees the nature and form of financial information that is intended for a particular purpose with the intended users, for example as specified under the financial reporting provisions of a contract or a project grant or as needed to support the entity's transactions or activities. The relevant contract may require use of an established financial reporting framework, such as a general purpose financial reporting framework established by an authorized or recognized standard-setting body or by law or regulation. Alternatively, the parties to the contract may agree on the use of a general purpose framework with modifications or adaptions that fit their particular needs. In that case, the applicable financial reporting framework may be described in the financial information and in the practitioner's report as being the financial reporting provisions of the specified contract rather than with reference to the modified financial reporting framework. In such cases, notwithstanding that the compiled financial information may be made more broadly available, the applicable financial reporting framework is a special purpose framework, and the practitioner is required to comply with the relevant reporting requirements of this HKSRS.

A33. When the applicable financial reporting framework is a special purpose financial reporting framework, the practitioner is required by this HKSRS to record any restrictions on either the intended use or distribution of the financial information in the engagement letter, and to state in the practitioner's report that the financial information is prepared using a special purpose financial reporting framework, and as a result may not be suitable for other purposes.

Responsibilities of Management (Ref: Para. (24(e))

A34. Under this HKSRS, the practitioner is required to obtain the agreement of management, or where applicable those charged with governance, on management's responsibilities in relation to both the financial information and the compilation engagement as a condition precedent to accepting the engagement. In smaller entities, management, or those charged with governance where applicable, may not be well-informed about what those responsibilities are, including those arising in applicable law or regulation. In order to obtain management's agreement on an informed basis, the practitioner may find it necessary to discuss those responsibilities with management in advance of seeking management's agreement on its responsibilities.

A35. If management does not acknowledge its responsibilities in the context of a compilation engagement, the practitioner is not able to undertake the engagement, and it is not appropriate for the practitioner to accept the engagement unless required to do so under applicable law or regulation. In circumstances where the practitioner is nevertheless required to accept the engagement, the practitioner may need to communicate with management about the importance of these matters and the implications for the engagement.

A36. The practitioner is entitled to rely on management to provide all relevant information for the compilation engagement on an accurate, complete and timely basis. The form of the information provided by management for the purpose of the engagement will vary in different engagement circumstances. In broad terms, it will comprise records, documents, explanations and other information relevant to the compilation of the financial information using the applicable financial reporting framework. The information provided may include, for example, information about management assumptions, intentions or plans underlying development of accounting estimates needed to compile the information under the applicable financial reporting framework.

Engagement Letter or Other Form of Written Agreement (Ref: Para. 25)

A37. It is in the interests of both management, and the engaging parties where different, and the practitioner that the practitioner sends an engagement letter to management and, where applicable, to the engaging parties prior to performing the compilation engagement, to help avoid misunderstandings with respect to the compilation engagement. An engagement letter confirms the practitioner's acceptance of the engagement and confirms such matters as:

- The objectives and scope of the engagement, including the understanding of the parties to the engagement that the engagement is not an assurance engagement.
- The intended use and distribution of the financial information, and any restrictions on its use or distribution (where applicable).
- The responsibilities of management in relation to the compilation engagement.
- The extent of the practitioner's responsibilities, including that the practitioner will not express an audit opinion or a review conclusion on the financial information.
- The form and content of the report to be issued by the practitioner for the engagement.

Form and Content of the Engagement Letter

A38. The form and content of the engagement letter may vary for each engagement. In addition to the matters required by this HKSRS, an engagement letter may make reference to, for example:

- Arrangements concerning the involvement of other practitioners and experts in some aspects of the compilation engagement.
- Arrangements to be made with the predecessor practitioner, if any, in the case of an initial engagement.
- The possibility that management or those charged with governance, as appropriate, may be requested to confirm in writing certain information or explanations conveyed orally to the practitioner during the engagement.
- Ownership of the information used for purposes of the compilation engagement, distinguishing between documents and information of the entity provided for the engagement and the practitioner's engagement documentation, having regard to applicable law and regulation.
- A request for management, and the engaging party if different, to acknowledge receipt of the engagement letter and to agree to the terms of the engagement outlined therein.

Illustrative Engagement Letter

A39. An illustrative engagement letter for a compilation engagement is set out in Appendix 1 to this HKSRS.

Recurring Engagements (Ref: Para. 26)

A40. The practitioner may decide not to send a new engagement letter or other written agreement each period. However, the following factors may indicate that it is appropriate to revise the terms of the compilation engagement, or to remind management or the engaging party, where applicable, of the existing terms of the engagement:

- Any indication that management or the engaging party, where applicable, misunderstands the objective and scope of the engagement.
- Any revised or special terms of the engagement.

- A recent change of senior management of the entity.
- A significant change in ownership of the entity.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements affecting the entity.
- A change in the applicable financial reporting framework.

Communication with Management and Those Charged with Governance (Ref: Para. 27)

A41. The appropriate timing for communications will vary with the circumstances of the compilation engagement. Relevant circumstances include the significance and nature of the matter and any action expected to be taken by management or those charged with governance. For example, it may be appropriate to communicate a significant difficulty encountered during the engagement as soon as practicable if management or those charged with governance are able to assist the practitioner to overcome the difficulty.

Performing the Engagement

The Practitioner's Understanding (Ref: Para. 28)

A42. Obtaining an understanding of the entity's business and its operations, including the entity's accounting system and accounting records, is an ongoing process that occurs throughout the compilation engagement. The understanding establishes a frame of reference within which the practitioner exercises professional judgment in compiling the financial information.

A43. The breadth and depth of the understanding the practitioner has or obtains about the entity's business and operations is less than that possessed by management. It is directed at the level that is sufficient for the practitioner to be able to compile the financial information under the terms of the engagement.

A44. Examples of matters the practitioner may consider in obtaining an understanding of the entity's business and operations and the applicable financial reporting framework include:

- The size and complexity of the entity and its operations.
- The complexity of the financial reporting framework.
- The entity's financial reporting obligations or requirements, whether they exist under applicable laws and regulation, under the provisions of a contract or other form of agreement with a third party, or in the context of voluntary financial reporting arrangements.
- The level of development of the entity's management and governance structure regarding management and oversight of the entity's accounting records and financial reporting systems that underpin the preparation of financial information of the entity.
- The level of development and complexity of the entity's financial accounting and reporting systems and related controls.
- The nature of the entity's assets, liabilities, revenues and expenses.

Compiling the Financial Information

Significant Judgments (Ref: Para.30)

A45. In some compilation engagements, the practitioner does not provide assistance to management with significant judgments. In other engagements, the practitioner may provide such assistance, for example, in relation to a required accounting estimate or helping management with its consideration of appropriate accounting policies. Where assistance is provided, discussion is needed so that management and those charged with governance, as appropriate, understand the significant judgments reflected in the financial information, and accept their responsibility for those judgments.

Reading the Financial Information (Ref: Para. 31)

A46. The practitioner's reading of the financial information is intended to assist the practitioner in fulfilling the practitioner's ethical obligations relevant to the compilation engagement.

Proposing Amendments to the Financial Information

Reference to or description of the applicable financial reporting framework (Ref: Para. 34(a))

A47. There may be circumstances when the applicable financial reporting framework is an established financial reporting framework with significant departures therefrom. If the description of the applicable financial reporting framework in the compiled financial information makes reference to the established framework with significant departures, the practitioner may need to consider whether the reference to the established framework is misleading in the circumstances of the engagement.

Amendment for material misstatements, and for the information not to be misleading (Ref: Para. 34(b)–(c))

A48. The practitioner's consideration of materiality is made in the context of the applicable financial reporting framework. Some financial reporting frameworks discuss the concept of materiality in the context of the preparation and presentation of financial information. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial information;
- Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial information are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

A49. If present in the applicable financial reporting framework, such a discussion provides a frame of reference for the practitioner in understanding materiality for the purpose of the compilation engagement. If not present, the above considerations provide the practitioner with a frame of reference.

A50. The practitioner's perception of the needs of users of the financial information affects the practitioner's view of materiality. In this context, it is reasonable for the practitioner to assume that users:

- Have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the financial information with reasonable diligence;

- Understand that financial information is prepared and presented to levels of materiality;

- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

- Make reasonable economic decisions on the basis of the information in the financial information.

A51. The applicable financial reporting framework may include the premise that the financial information is prepared on the going concern basis. If the practitioner becomes aware that uncertainties exist regarding the entity's ability to continue as a going concern, the practitioner may, as appropriate, suggest a more appropriate presentation under the applicable financial reporting framework, or appropriate disclosures concerning the entity's ability to continue as a going concern, in order to be in compliance with that framework, and to avoid the financial information being misleading.

Conditions that Require the Practitioner to Withdraw from the Engagement (Ref: Para. 33, 35)

A52. In circumstances addressed by the requirements of this HKSRS where withdrawal from the engagement is necessary, the responsibility to inform management and those charged with governance of the reasons for withdrawing provides an opportunity to explain the practitioner's ethical obligations.

Documentation (Ref: Para. 38)

A53. The documentation required by this HKSRS serves a number of purposes, including the following:

- Providing a record of matters of continuing relevance to future compilation engagements.

- Enabling the engagement team, as applicable, to be accountable for its work, including recording the completion of the engagement.

A54. The practitioner may consider also including in the engagement documentation a copy of the entity's trial balance, summary of significant accounting records or other information that the practitioner used to perform the compilation.

A55. In recording how the compiled financial information reconciles with the underlying records, documents, explanations and other information provided by management for the purpose of the compilation engagement, the practitioner may, for example, keep a schedule showing the reconciliation of the entity's general ledger account balances to the compiled financial information, including any adjusting journal entries or other amendments to the financial information that the practitioner has agreed with management in the course of the engagement.

The Practitioner's Report (Ref: Para. 40)

A56. The written report encompasses reports issued in hard copy format and those issued using an electronic medium.

A57. When the practitioner is aware that the compiled financial information and the practitioner's report will be included in a document that contains other information, such as a financial report, the practitioner may consider, if the form of presentation allows, identifying the page numbers on which the financial information is presented. This helps users to identify the financial information to which the practitioner's report relates.

Addressees of the Report (Ref: Para. 40(b))

A58. Law or regulation may specify to whom the practitioner's report is to be addressed in the particular jurisdiction. The practitioner's report is normally addressed to the party who engaged the practitioner under the terms of the engagement, ordinarily the management of the entity.

Financial Information Prepared Using a Special Purpose Financial Reporting Framework (Ref: Para. 40(j))

A59. Under this HKSRS, if the financial information is prepared using a special purpose financial reporting framework, the practitioner's report is required to draw the attention of readers of the report to the special purpose financial reporting framework used in the financial information, and to state that the financial information may therefore not be suitable for other purposes. This may be supplemented by an additional clause that restricts either the distribution or use, or both, of the practitioner's report to the intended users only.

A60. Financial information prepared for a particular purpose may be obtained by parties other than the intended users, who may seek to use the information for purposes other than those for which the information was intended. For example, a regulator may require certain entities to provide financial statements prepared using a special purpose financial reporting framework, and those financial statements to be on public record. The fact of the wider availability of those financial statements to parties other than the intended users does not mean the financial statements would then become general purpose financial statements. The practitioner's statements required to be included in the practitioner's report are needed to draw readers' attention to the fact that the financial statements are prepared under a special purpose financial reporting framework, and may not, therefore, be suitable for other purposes.

Restriction on Distribution and Use of the Practitioner's Report

A61. The practitioner may consider it appropriate to indicate that the practitioner's report is intended solely for the specified intended users of the financial information. Depending on the law or regulation of the particular jurisdiction, this may be achieved by restricting either the distribution or use, or both, of the practitioner's report to the intended users only.

Completion of the Compilation Engagement and Dating of the Practitioner's Report (Ref: Para. 37, 38, 41)

A62. The process that exists within the entity for the approval of the financial information by management, or by those charged with governance as appropriate, is a relevant consideration for the practitioner when completing the compilation engagement. Depending on the nature and purpose of the financial information, there may be an established approval process that management or those charged with governance are required to follow, or that is prescribed in applicable law and regulation, for the preparation and finalization of financial information or financial statements of the entity.

Illustrative Reports (Ref: Para. 40)

A63. Appendix 2 to this HKSRS contains illustrations of practitioners' compilation reports incorporating the required elements of the report.

Appendix 1

(Ref: Para. A39)

Illustrative Engagement Letter for a Compilation Engagement

The following is an example of an engagement letter for a compilation engagement that illustrates the relevant requirements and guidance contained in this HKSRS. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this HKSRS. It will need to be adapted according to the requirements and circumstances of individual compilation engagements. It is drafted to refer to the compilation of financial statements for a single reporting period and would require adaptation if intended or expected to apply to a recurring engagement as described in this HKSRS. It may be appropriate to seek legal advice that any proposed letter is suitable.

This engagement letter illustrates the following circumstances:

- The financial statements are to be compiled for sole use by the management of a company (ABC Company), and use of the financial statements will be restricted to management. Use and distribution of the practitioner's report is also restricted to management.
- The compiled financial statements will comprise only the balance sheet of the company as at 31 December 20X1 and the income statement for the year then ended, without notes. Management has determined that the financial statements be prepared on an accrual basis as described.

***

To the Management[6] of ABC Company:

[The objective and scope of the compilation engagement]

You have requested that we provide the following services:

On the basis of information that you will provide, we will assist you in the preparation and presentation of the following financial statements for ABC Company: the balance sheet of ABC Company as at 31 December 20X1 and the income statement for the year then ended, on the historical cost basis, reflecting all cash transactions with the addition of trade accounts payable, trade accounts receivable less an allowance for doubtful accounts, inventory accounted for on an average cost basis, current income taxes payable as at the reporting date, and capitalization of significant long-lived assets at historical cost amortized over their estimated useful lives on the straight-line basis. These financial statements will not include explanatory notes, other than a note describing the basis of accounting as set out in this engagement letter.

The purpose for which the financial statements will be used is to provide full-year financial information showing the entity's financial position at the financial reporting date of 31 December 20X1 and financial performance for the year then ended. The financial statements will be solely for your use, and will not be distributed to other parties.

[6] Throughout this illustrative engagement letter, references to "you," "we," "us," "management," "those charged with governance" and "practitioner" would be used or amended as appropriate in the circumstances.

Our Responsibilities

A compilation engagement involves applying expertise in accounting and financial reporting to assist you in the preparation and presentation of financial information. Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provide to us for the compilation engagement, or otherwise to gather evidence to express an audit opinion or a review conclusion. Accordingly, we will not express an audit opinion or a review conclusion on whether the financial statements are prepared in accordance with the basis of accounting you have specified, as described above.

We will perform the compilation engagement in accordance with the Hong Kong Standard on Related Services (HKSRS) 4410 (Revised), *Compilation Engagements*. HKSRS 4410 (Revised) requires that, in undertaking this engagement, we comply with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care. For that purpose, we are required to comply with the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants* (the Code).

Your Responsibilities

The compilation engagement to be performed is conducted on the basis that you acknowledge and understand that our role is to assist you in the preparation and presentation of the financial statements in accordance with the financial reporting framework you have adopted for the financial statements. Accordingly, you have the following overall responsibilities that are fundamental to our undertaking the compilation engagement in accordance with HKSRS 4410 (Revised):

(a) Responsibility for the financial statements and the preparation and presentation thereof in accordance with a financial reporting framework that is acceptable in view of the intended use of the financial statements and the intended users.

(b) Responsibility for the accuracy and completeness of the records, documents, explanations and other information you provide to us for the purpose of compiling the financial statements.

(c) Responsibility for the judgments needed in the preparation and presentation of the financial statements, including those for which we may provide assistance in the course of the compilation engagement.

Our Compilation Report

As part of our engagement, we will issue our report attached to the financial statements compiled by us, which will describe the financial statements, and the work we performed for this compilation engagement [see attached]. The report will also note that the use of the financial statements is restricted to the purpose set out in this engagement letter, and that use and distribution of our report provided for the compilation engagement is restricted to you, as the management of ABC Company.[6a]

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our engagement to compile the financial statements described herein, and our respective responsibilities.

[*Other relevant information*]

[*Insert other information, such as fee arrangements, billings and other specific terms, as appropriate*.]

XYZ & Co.

[6a] Practitioners may consider it appropriate to include a limitation of liability clause in accordance with their risk management policies.

Acknowledged and agreed on behalf of the management of ABC Company by

(signed)

....
Name and Title

Date

Appendix 2

(Ref: Para. A63)

Illustrative Practitioners' Compilation Reports

Compilation Engagement for General Purpose Financial Statements

- Illustration 1: Practitioner's report for an engagement to compile financial statements using a general purpose financial reporting framework.

Compilation Engagement for Financial Statements Prepared for a Special Purpose

- Illustration 2: Practitioner's report for an engagement to compile financial statements using a modified general purpose financial reporting framework.

Compilation Engagements for Financial Information Prepared for a Special Purpose where Use or Distribution of the Financial Information Is Restricted to the Intended Users

- Illustration 3: Practitioner's report for an engagement to compile financial statements using the basis of accounting specified in a contract.

- Illustration 4: Practitioner's report for an engagement to compile financial statements using a basis of accounting selected by the management of an entity for financial information required for management's own purposes.

- Illustration 5: Practitioner's report for an engagement to compile financial information that is an element, account or item, being [*insert appropriate reference to information required for a regulatory compliance purpose*].

Illustration 1: Practitioner's report for an engagement to compile financial statements using a general purpose financial reporting framework.

- General purpose financial statements required under applicable law that specifies that the entity's financial statements are to be prepared applying Hong Kong Financial Reporting Standards for Private Entities (HKFRS-PE).

PRACTITIONER'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the statement of financial position of ABC Company as at 31 December 20X1, 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.

We performed this compilation engagement in accordance with Hong Kong Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards for Private Entities (HKFRS-PE). We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility. [6b]

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with HKFRS-PE.

[Practitioner's signature]

[Date of practitioner's report]

[Practitioner's address]

[6b] Practitioners may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditor's Duty of Care To Third Parties and The Audit Report".

Illustration 2: Practitioner's report for an engagement to compile financial statements using a modified general purpose financial reporting framework.

- Financial statements prepared using a general purpose financial reporting framework adopted by management on a modified basis.
- The applicable financial reporting framework is Hong Kong Financial Reporting Standards for Private Entities (HKFRS-PE) excluding the treatment of property, which has been revalued rather than being carried at historical cost.
- Use or distribution of the financial statements is not restricted.

PRACTITIONER'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the statement of financial position of ABC Company as at 31 December 20X1, 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.

We performed this compilation engagement in accordance with Hong Kong Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements on the basis of accounting described in Note X to the financial statements. We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with the basis of accounting described in Note X.

As stated in Note X, the financial statements are prepared and presented in accordance with Hong Kong Financial Reporting Standards for Private Entities (HKFRS-PE), excluding property which is revalued in the financial statements rather than being carried at historical cost. The financial statements are prepared for the purpose described in Note Y to the financial statements. Accordingly, these financial statements may not be suitable for other purposes.[6c]

[Practitioner's signature]

[Date of practitioner's report]

[Practitioner's address]

[6c] Practitioners may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditor's Duty of Care To Third Parties and The Audit Report".

Illustration 3: Practitioner's report for an engagement to compile financial statements using the basis of accounting specified in a contract.

- Financial statements prepared to comply with the provisions of a contract, applying the basis of accounting specified in the contract.
- The practitioner is engaged by a party other than management or those charged with governance of the entity.
- The financial statements are intended for use only by the parties specified in the contract.
- Distribution and use of the practitioner's report is restricted to the intended users of the financial statements specified in the contract.

PRACTITIONER'S COMPILATION REPORT

[To the Engaging Party[7]]

We have compiled the accompanying financial statements of ABC Company ("the Company") based on information provided by the management of the Company ("management"). These financial statements comprise *[name all the elements of the financial statements prepared under the basis of accounting specified in the Contract and the period/date to which they relate*].

We performed this compilation engagement in accordance with Hong Kong Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist management in the preparation and presentation of these financial statements on the basis of accounting described in Note X to the financial statements. We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are management's responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information provided to us by management to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with the basis of accounting described in Note X.

As stated in Note X, the financial statements are prepared and presented on the basis described in Clause Z of the provisions of the Company's contract with XYZ Limited dated *[insert date of the relevant contract/agreement*] ("the Contract"), and for the purpose described in Note Y to the financial statements. Accordingly, these financial statements are intended for use only by the parties specified in the Contract, and may not be suitable for other purposes.

Our compilation report is intended solely for the parties specified in the Contract, and should not be distributed to other parties.[7a]

[Practitioner's signature]

[Date of practitioner's report]

[Practitioner's address]

---

7 Alternatively, the appropriate addressee specified in the relevant contract

7a Practitioners may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditor's Duty of Care To Third Parties and The Audit Report".

Illustration 4: Practitioner's report for an engagement to compile financial statements using a basis of accounting selected by management of an entity for financial information required for management's own purposes.

- Financial statements prepared using a special purpose financial reporting framework, intended for use only by the management of a company for management's own purposes.
- The financial statements incorporate certain accruals, and comprise only a balance sheet, an income statement, and a single note that refers to the basis of accounting used for the financial statements.
- The financial statements are intended for use only by management.
- Distribution and use of the practitioner's report is restricted to management.

PRACTITIONER'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the balance sheet of ABC Company as at 31 December 20X1 and an income statement for the year then ended.

We performed this compilation engagement in accordance with Hong Kong Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements on the basis of accounting described in Note X to the financial statements. We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with the basis of accounting described in Note X.

Note X states the basis on which these financial statements are prepared, and their purpose is described in Note Y. Accordingly, these financial statements are for your use only, and may not be suitable for other purposes.

Our compilation report is intended solely for your use in your capacity as management of ABC Company, and should not be distributed to other parties.[7b]

[Practitioner's signature]

[Date of practitioner's report]

[Practitioner's address]

[7b] Practitioners may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditor's Duty of Care To Third Parties and The Audit Report".

Illustration 5: Practitioner's report for an engagement to compile financial information that is an element, account or item, being [insert appropriate reference to information required for a regulatory compliance purpose].

- Financial information prepared for a special purpose, i.e., to comply with financial reporting requirements established by a regulator, in accordance with provisions established by the regulator prescribing the form and content of the financial information.
- The applicable financial reporting framework is a compliance framework.
- The financial information is intended to meet the needs of particular users, and use of the financial information is restricted to those users.
- Distribution of the practitioner's report is restricted to the intended users.

PRACTITIONER'S COMPILATION REPORT

[To the Management of ABC Company[8]]

We have compiled the accompanying schedule of [*identify the compiled financial information*] of ABC Company as at 31 December 20X1 ("the Schedule") based on information you have provided.

We performed this compilation engagement in accordance with Hong Kong Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of the Schedule as prescribed by [*insert name of or reference to the relevant regulation*]. We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

This Schedule and the accuracy and completeness of the information used to compile it are your responsibility.

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile the Schedule. Accordingly, we do not express an audit opinion or a review conclusion on whether the Schedule is prepared in accordance with [*insert name of or reference to applicable financial reporting framework as specified in the relevant regulation*].

As stated in Note X, the Schedule is prepared and presented on the basis prescribed by [*insert name of or reference to the applicable financial reporting framework as specified in the relevant regulation*], for the purpose of ABC Company's compliance with [insert name of or reference to the relevant regulation]. Accordingly, the Schedule is for use only in connection with that purpose and may not be suitable for any other purpose.

Our compilation report is intended solely for the use of ABC Company and Regulator F, and should not be distributed to parties other than ABC Company or Regulator F.[8a]

[Practitioner's signature]

[Date of the practitioner's report]

[Practitioner's address]

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8 Alternatively, the appropriate addressee specified in the applicable financial reporting requirements

8a Practitioners may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditor's Duty of Care To Third Parties and The Audit Report".

HKAPG 1000
Issued July 2012

Effective upon issue

Hong Kong Auditing Practice Guidance 1000

Special Considerations in Auditing Financial Instruments

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

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HONG KONG AUDITING PRACTICE GUIDANCE 1000

SPECIAL CONSIDERATIONS IN AUDITING FINANCIAL INSTRUMENTS

CONTENTS

Hong Kong Auditing Practice Guidance (HKAPG) 1000, *Special Considerations in Auditing Financial Instruments*, should be read in conjunction with the *Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. HKAPGs do not impose additional requirements on auditors beyond those included in the Hong Kong Standards on Auditing (HKSAs), nor do they change the auditor's responsibility to comply with all HKSAs relevant to the audit. HKAPGs provide practical assistance to auditors. They also provide material that firms can use in developing their training programs and internal guidance.

Introduction

1. Financial instruments may be used by financial and non-financial entities of all sizes for a variety of purposes. Some entities have large holdings and transaction volumes while other entities may only engage in a few financial instrument transactions. Some entities may take positions in financial instruments to assume and benefit from risk while other entities may use financial instruments to reduce certain risks by hedging or managing exposures. This Hong Kong Auditing Practice Guidance (HKAPG) is relevant to all of these situations.

2. The following Hong Kong Standards on Auditing (HKSAs) are particularly relevant to audits of financial instruments:

   (a) HKSA 540[1] deals with the auditor's responsibilities relating to auditing accounting estimates, including accounting estimates related to financial instruments measured at fair value;

   (b) HKSA 315[2] and HKSA 330[3] deal with identifying and assessing risks of material misstatement and responding to those risks; and

   (c) HKSA 500[4] explains what constitutes audit evidence and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

3. The purpose of this HKAPG is to provide:

   (a) Background information about financial instruments (Section I); and

   (b) Discussion of audit considerations relating to financial instruments (Section II).

HKAPGs provide practical assistance to auditors. They also provide material that firms can use in developing their training programs and internal guidance.

4. This HKAPG is relevant to entities of all sizes, as all entities may be subject to risks of material misstatement when using financial instruments.

5. The guidance on valuation[5] in this HKAPG is likely to be more relevant for financial instruments measured or disclosed at fair value, while the guidance on areas other than valuation applies equally to financial instruments either measured at fair value or amortized cost. This HKAPG is also applicable to both financial assets and financial liabilities. This HKAPG does not deal with instruments such as:

   (a) The simplest financial instruments such as cash, simple loans, trade accounts receivable and trade accounts payable;

   (b) Investments in unlisted equity instruments; or

   (c) Insurance contracts.

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1 HKSA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

2 HKSA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

3 HKSA 330, *The Auditor's Responses to Assessed Risks*

4 HKSA 500, *Audit Evidence*

5 In this HKAPG, the terms "valuation" and "measurement" are used interchangeably.

6. Also, this HKAPG does not deal with specific accounting issues relevant to financial instruments, such as hedge accounting, profit or loss on inception (often known as “Day 1” profit or loss), offsetting, risk transfers or impairment, including loan loss provisioning. Although these subject matters can relate to an entity’s accounting for financial instruments, a discussion of the auditor’s consideration regarding how to address specific accounting requirements is beyond the scope of this HKAPG.

7. An audit in accordance with HKSAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities. Such responsibilities subsume making fair value measurements. This HKAPG does not impose responsibilities on management or those charged with governance nor override laws and regulation that govern their responsibilities.

8. This HKAPG has been written in the context of general purpose fair presentation financial reporting frameworks, but may also be useful, as appropriate in the circumstance, in other financial reporting frameworks such as special purpose financial reporting frameworks.

9. This HKAPG focuses on the assertions of valuation, and presentation and disclosure, but also covers, in less detail, completeness, accuracy, existence, and rights and obligations.

10. Financial instruments are susceptible to estimation uncertainty, which is defined in HKSA 540 as “the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.”[6] Estimation uncertainty is affected by the complexity of financial instruments, among other factors. The nature and reliability of information available to support the measurement of financial instruments varies widely, which affects the estimation uncertainty associated with their measurement. This HKAPG uses the term “measurement uncertainty” to refer to the estimation uncertainty associated with fair value measurements.

Section I—Background Information about Financial Instruments

11. Different definitions of financial instruments may exist among financial reporting frameworks. For example, Hong Kong Financial Reporting Standards (HKFRS) define a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.[7] Financial instruments may be cash, the equity of another entity, the contractual right or obligation to receive or deliver cash or exchange financial assets or liabilities, certain contracts settled in an entity’s own equity instruments, certain contracts on non-financial items, or certain contracts issued by insurers that do not meet the definition of an insurance contract. This definition encompasses a wide range of financial instruments from simple loans and deposits to complex derivatives, structured products, and some commodity contracts.

12. Financial instruments vary in complexity, though the complexity of the financial instrument can come from difference sources, such as:

- A very high volume of individual cash flows, where a lack of homogeneity requires analysis of each one or a large number of grouped cash flows to evaluate, for example, credit risk (for example, collateralized debt obligations (CDOs)).
- Complex formulae for determining the cash flows.
- Uncertainty or variability of future cash flows, such as that arising from credit risk, option contracts or financial instruments with lengthy contractual terms.

The higher the variability of cash flows to changes in market conditions, the more complex and uncertain the fair value measurement of the financial instrument is likely to be. In addition, sometimes financial instruments that, ordinarily, are relatively easy to value become complex to value because of particular circumstances, for example, instruments for which the market has

[6] HKSA 540, paragraph 7(c)

[7] Hong Kong Accounting Standard (HKAS) 32, *Financial Instruments: Presentation*, paragraph 11

become inactive or which have lengthy contractual terms. Derivatives and structured products become more complex when they are a combination of individual financial instruments. In addition, the accounting for financial instruments under certain financial reporting frameworks or certain market conditions may be complex.

13. Another source of complexity is the volume of financial instruments held or traded. While a "plain vanilla" interest rate swap may not be complex, an entity holding a large number of them may use a sophisticated information system to identify, value and transact these instruments.

Purpose and Risks of Using Financial Instruments

14. Financial instruments are used for:

- Hedging purposes (that is, to change an existing risk profile to which an entity is exposed). This includes:
  - The forward purchase or sale of currency to fix a future exchange rate;
  - Converting future interest rates to fixed rates or floating rates through the use of swaps; and
  - The purchase of option contracts to provide an entity with protection against a particular price movement, including contracts which may contain embedded derivatives;
- Trading purposes (for example, to enable an entity to take a risk position to benefit from short term market movements); and
- Investment purposes (for example, to enable an entity to benefit from long term investment returns).

15. The use of financial instruments can reduce exposures to certain business risks, for example changes in exchange rates, interest rates and commodity prices, or a combination of those risks. On the other hand, the inherent complexities of some financial instruments also may result in increased risk.

16. Business risk and the risk of material misstatement increase when management and those charged with governance:

- Do not fully understand the risks of using financial instruments and have insufficient skills and experience to manage those risks;
- Do not have the expertise to value them appropriately in accordance with the applicable financial reporting framework;
- Do not have sufficient controls in place over financial instrument activities; or
- Inappropriately hedge risks or speculate.

17. Management's failure to fully understand the risks inherent in a financial instrument can have a direct effect on management's ability to manage these risks appropriately, and may ultimately threaten the viability of the entity.

18. The principal types of risk applicable to financial instruments are listed below. This list is not meant to be exhaustive and different terminology may be used to describe these risks or classify the components of individual risks.

    (a) Credit (or counterparty) risk is the risk that one party to a financial instrument will cause a financial loss to another party by failing to discharge an obligation and is often associated with default. Credit risk includes settlement risk, which is the risk that one side of a transaction will be settled without consideration being received from the customer or counterparty.

    (b) Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Examples of market risk include currency risk, interest rate risk, commodity and equity price risk.

    (c) Liquidity risk includes the risk of not being able to buy or sell a financial instrument at an appropriate price in a timely manner due to a lack of marketability for that financial instrument.

    (d) Operational risk relates to the specific processing required for financial instruments. Operational risk may increase as the complexity of a financial instrument increases, and poor management of operational risk may increase other types of risk. Operational risk includes:

        (i) The risk that confirmation and reconciliation controls are inadequate resulting in incomplete or inaccurate recording of financial instruments;

        (ii) The risks that there is inappropriate documentation of transactions and insufficient monitoring of these transactions;

        (iii) The risk that transactions are incorrectly recorded, processed or risk managed and, therefore, do not reflect the economics of the overall trade;

        (iv) The risk that undue reliance is placed by staff on the accuracy of valuation techniques, without adequate review, and transactions are therefore incorrectly valued or their risk is improperly measured;

        (v) The risk that the use of financial instruments is not adequately incorporated into the entity's risk management policies and procedures;

        (vi) The risk of loss resulting from inadequate or failed internal processes and systems, or from external events, including the risk of fraud from both internal and external sources;

        (vii) The risk that there is inadequate or non-timely maintenance of valuation techniques used to measure financial instruments; and

        (viii) Legal risk, which is a component of operational risk, and relates to losses resulting from a legal or regulatory action that invalidates or otherwise precludes performance by the end user or its counterparty under the terms of the contract or related netting arrangements. For example, legal risk could arise from insufficient or incorrect documentation for the contract, an inability to enforce a netting arrangement in bankruptcy, adverse changes in tax laws, or statutes that prohibit entities from investing in certain types of financial instruments.

19. Other considerations relevant to risks of using financial instruments include:

- The risk of fraud that may be increased if, for example, an employee in a position to perpetrate a financial fraud understands both the financial instruments and the processes for accounting for them, but management and those charged with governance have a lesser degree of understanding.

- The risk that master netting arrangements[8] may not be properly reflected in the financial statements.

- The risk that some financial instruments may change between being assets or liabilities during their term and that such change may occur rapidly.

Controls Relating to Financial Instruments

20. The extent of an entity's use of financial instruments and the degree of complexity of the instruments are important determinants of the necessary level of sophistication of the entity's internal control. For example, smaller entities may use less structured products and simple processes and procedures to achieve their objectives.

21. Often, it is the role of those charged with governance to set the tone regarding, and approve and oversee the extent of use of, financial instruments while it is management's role to manage and monitor the entity's exposures to those risks. Management and, where appropriate, those charged with governance are also responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework. An entity's internal control over financial instruments is more likely to be effective when management and those charged with governance have:

(a) Established an appropriate control environment, active participation by those charged with governance in controlling the use of financial instruments, a logical organizational structure with clear assignment of authority and responsibility, and appropriate human resource policies and procedures. In particular, clear rules are needed on the extent to which those responsible for financial instrument activities are permitted to act. Such rules have regard to any legal or regulatory restrictions on using financial instruments. For example, certain public sector entities may not have the power to conduct business using derivatives;

(b) Established a risk management process relative to the size of the entity and the complexity of its financial instruments (for example, in some entities a formal risk management function may exist);

(c) Established information systems that provide those charged with governance with an understanding of the nature of the financial instrument activities and the associated risks, including adequate documentation of transactions;

(d) Designed, implemented and documented a system of internal control to:

   ○ Provide reasonable assurance that the entity's use of financial instruments is within its risk management policies;

   ○ Properly present financial instruments in the financial statements;

[8] An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a master netting arrangement with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default of any one contract.

- Ensure that the entity is in compliance with applicable laws and regulations; and
- Monitor risk.

The Appendix provides examples of controls that may exist in an entity that deals in a high volume of financial instrument transactions; and

(e) Established appropriate accounting policies, including valuation policies, in accordance with the applicable financial reporting framework.

22. Key elements of risk management processes and internal control relating to an entity's financial instruments include:

- Setting an approach to define the amount of risk exposure that the entity is willing to accept when engaging in financial instrument transactions (this may be referred to as its "risk appetite"), including policies for investing in financial instruments, and the control framework in which the financial instrument activities are conducted;
- Establishing processes for the documentation and authorization of new types of financial instrument transactions which consider the accounting, regulatory, legal, financial and operational risks that are associated with such instruments;
- Processing financial instrument transactions, including confirmation and reconciliation of cash and asset holdings to external statements, and the payments process;
- Segregation of duties between those investing or trading in the financial instruments and those responsible for processing, valuing and confirming such instruments. For example, a model development function that is involved in assisting in pricing deals is less objective than one that is functionally and organizationally separate from the front office;
- Valuation processes and controls, including controls over data obtained from third-party pricing sources; and
- Monitoring of controls.

23. The nature of risks often differs between entities with a high volume and variety of financial instruments and those with only a few financial instrument transactions. This results in different approaches to internal control. For example:

- Typically, an institution with high volumes of financial instruments will have a dealing room type environment in which there are specialist traders and segregation of duties between those traders and the back office (which refers to the operations function that data-checks trades that have been conducted, ensuring that they are not erroneous, and transacting the required transfers). In such environments, the traders will typically initiate contracts verbally over the phone or via an electronic trading platform. Capturing relevant transactions and accurately recording financial instruments in such an environment is significantly more challenging than for an entity with only a few financial instruments, whose existence and completeness often can be confirmed with a bank confirmation to a few banks.
- On the other hand, entities with only a small number of financial instruments often do not have segregation of duties, and access to the market is limited. In such cases, although it may be easier to identify financial instrument transactions, there is a risk that management may rely on a limited number of personnel, which may increase the risk that unauthorized transactions may be initiated or transactions may not be recorded.

Completeness, Accuracy, and Existence

24. Paragraphs 25–33 describe controls and processes which may be in place in entities with a high volume of financial instrument transactions, including those with trading rooms. By contrast, an entity that does not have a high volume of financial instrument transactions may not have these controls and processes but may instead confirm their transactions with the counterparty or clearing house. Doing so may be relatively straightforward in that the entity may only transact with one or two counterparties.

Trade Confirmations and Clearing Houses

25. Generally, for transactions undertaken by financial institutions, the terms of financial instruments are documented in confirmations exchanged between counterparties and legal agreements. Clearing houses serve to monitor the exchange of confirmations by matching trades and settling them. A central clearing house is associated with an exchange and entities that clear through clearing houses typically have processes to manage the information delivered to the clearing house.

26. Not all transactions are settled through such an exchange. In many other markets there is an established practice of agreeing the terms of transactions before settlement begins. To be effective, this process needs to be run separately from those who trade the financial instruments to minimize the risk of fraud. In other markets, transactions are confirmed after settlement has begun and sometimes confirmation backlogs result in settlement beginning before all terms have been fully agreed. This presents additional risk because the transacting entities need to rely on alternative means of agreeing trades. These may include:

    - Enforcing rigorous reconciliations between the records of those trading the financial instruments and those settling them (strong segregation of duties between the two are important), combined with strong supervisory controls over those trading the financial instruments to ensure the integrity of the transactions;

    - Reviewing summary documentation from counterparties that highlights the key terms even if the full terms have not been agreed; and

    - Thorough review of traders' profits and losses to ensure that they reconcile to what the back office has calculated.

Reconciliations with Banks and Custodians

27. Some components of financial instruments, such as bonds and shares, may be held in separate depositories. In addition, most financial instruments result in payments of cash at some point and often these cash flows begin early in the contract's life. These cash payments and receipts will pass through an entity's bank account. Regular reconciliation of the entity's records to external banks' and custodians' records enables the entity to ensure transactions are properly recorded.

28. It should be noted that not all financial instruments result in a cash flow in the early stages of the contract's life or are capable of being recorded with an exchange or custodian. Where this is the case, reconciliation processes will not identify an omitted or inaccurately recorded trade and confirmation controls are more important. Even where such a cash flow is accurately recorded in the early stages of an instrument's life, this does not ensure that all characteristics or terms of the instrument (for example, the maturity or an early termination option) have been recorded accurately.

29. In addition, cash movements may be quite small in the context of the overall size of the trade or the entity's own balance sheet and may therefore be difficult to identify. The value of reconciliations is enhanced when finance, or other back office staff, review entries in all general ledger accounts to ensure that they are valid and supportable. This process will help identify if the other side to cash entries relating to financial instruments has not been properly recorded. Reviewing suspense and clearing accounts is important regardless of the account balance, as there may be offsetting reconciling items in the account.

30. In entities with a high volume of financial instrument transactions, reconciliation and confirmation controls may be automated and, if so, adequate IT controls need to be in place to support them. In particular, controls are needed to ensure that data is completely and accurately picked up from external sources (such as banks and custodians) and from the entity's records and is not tampered with before or during reconciliation. Controls are also needed to ensure that the criteria on which entries are matched are sufficiently restrictive to prevent inaccurate clearance of reconciling items.

Other Controls over Completeness, Accuracy, and Existence

31. The complexity inherent in some financial instruments means that it will not always be obvious how they should be recorded in the entity's systems. In such cases, management may set up control processes to monitor policies that prescribe how particular types of transactions are measured, recorded and accounted for. These policies are typically established and reviewed in advance by suitably qualified personnel who are capable of understanding the full effects of the financial instruments being booked.

32. Some transactions may be cancelled or amended after initial execution. Application of appropriate controls relating to cancellation or amendment can mitigate the risks of material misstatement due to fraud or error. In addition, an entity may have a process in place to reconfirm trades that are cancelled or amended.

33. In financial institutions with a high volume of trading, a senior employee typically reviews daily profits and losses on individual traders' books to evaluate whether they are reasonable based on the employee's knowledge of the market. Doing so may enable management to determine that particular trades were not completely or accurately recorded, or may identify fraud by a particular trader. It is important that there are transaction authorization procedures that support the more senior review.

Valuation of Financial Instruments

Financial Reporting Requirements

34. In many financial reporting frameworks, financial instruments, including embedded derivatives, are often measured at fair value for the purpose of balance sheet presentation, calculating profit or loss, and/or disclosure. In general, the objective of fair value measurement is to arrive at the price at which an orderly transaction would take place between market participants at the measurement date under current market conditions; that is, it is not the transaction price for a forced liquidation or distressed sale. In meeting this objective, all relevant available market information is taken into account.

35. Fair value measurements of financial assets and financial liabilities may arise both at the initial recording of transactions and later when there are changes in value. Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks. For example, such changes may be recorded as profit or loss, or may be recorded in the other comprehensive income. Also, depending on the applicable financial reporting framework, the whole financial instrument or only a component of it (for example, an embedded derivative when it is separately accounted for) may be required to be measured at fair value.

36. Some financial reporting frameworks establish a fair value hierarchy to develop increased consistency and comparability in fair value measurements and related disclosures. The inputs may be classified into different levels such as:

- Level 1 inputs—Quoted prices (unadjusted) in active markets for identical financial assets or financial liabilities that the entity can access at the measurement date.

- Level 2 inputs—Inputs other than quoted prices included within level 1 that are observable for the financial asset or financial liability, either directly or indirectly. If the financial asset or financial liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the financial asset or financial liability. Level 2 inputs include the following:

  - Quoted prices for similar financial assets or financial liabilities in active markets.

  - Quoted prices for identical or similar financial assets or financial liabilities in markets that are not active.

  - Inputs other than quoted prices that are observable for the financial asset or financial liability (for example, interest rates and yield curves observable at commonly quoted intervals, implied volatilities and credit spreads).

  - Inputs that are derived principally from, or corroborated by, observable market data by correlation or other means (market-corroborated inputs).

- Level 3 inputs—Unobservable inputs for the financial asset or financial liability. Unobservable inputs are used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the financial asset or financial liability at the measurement date.

In general, measurement uncertainty increases as a financial instrument moves from level 1 to level 2, or level 2 to level 3. Also, within level 2 there may be a wide range of measurement uncertainty depending on the observability of inputs, the complexity of the financial instrument, its valuation, and other factors.

37. Certain financial reporting frameworks may require or permit the entity to adjust for measurement uncertainties, in order to adjust for risks that a market participant would make in the pricing to take account of the uncertainties of the risks associated with the pricing or cash flows of the financial instrument. For example:

- Model adjustments. Some models may have a known deficiency or the result of calibration may highlight the deficiency for the fair value measurement in accordance with the financial reporting framework.

- Credit-risk adjustments. Some models do not take into account credit risk, including counterparty risk or own credit risk.

- Liquidity adjustments. Some models calculate a mid-market price, even though the financial reporting framework may require use of a liquidity adjusted amount such as a bid/offer spread. Another, more judgmental, liquidity adjustment recognizes that some financial instruments are illiquid which affects the valuation.

- Other risk adjustments. A value measured using a model that does not take into account all other factors that market participants would consider in pricing the financial instrument may not represent fair value on the measurement date, and therefore may need to be adjusted separately to comply with the applicable financial reporting framework.

Adjustments are not appropriate if they adjust the measurement and valuation of the financial instrument away from fair value as defined by the applicable financial reporting framework, for example for conservatism.

Observable and Unobservable Inputs

38. As mentioned above, financial reporting frameworks often categorize inputs according to the degree of observability. As activity in a market for financial instruments declines and the observability of inputs declines, measurement uncertainty increases. The nature and reliability of information available to support valuation of financial instruments varies depending on the observability of inputs to its measurement, which is influenced by the nature of the market (for example, the level of market activity and whether it is through an exchange or over-the-counter (OTC)). Accordingly, there is a continuum of the nature and reliability of evidence used to support valuation, and it becomes more difficult for management to obtain information to support a valuation when markets become inactive and inputs become less observable.

39. When observable inputs are not available, an entity uses unobservable inputs (level 3 inputs) that reflect the assumption that market participants would use when pricing the financial asset or the financial liability, including assumptions about risk. Unobservable inputs are developed using the best information available in the circumstances. In developing unobservable inputs, an entity may begin with its own data, which is adjusted if reasonably available information indicates that (a) other market participants would use different data or (b) there is something particular to the entity that is not available to other market participants (for example, an entity-specific synergy).

Effects of Inactive Markets

40. Measurement uncertainty increases and valuation is more complicated when the markets in which financial instruments or their component parts are traded become inactive. There is no clear point at which an active market becomes inactive, though financial reporting frameworks may provide guidance on this issue. Characteristics of an inactive market include a significant decline in the volume and level of trading activity, available prices vary significantly over time or among market participants or the prices are not current. However, assessing whether a market is inactive requires judgment.

41. When markets are inactive, prices quoted may be stale (that is, out of date), may not represent prices at which market participants may trade or may represent forced transactions (such as when a seller is required to sell an asset to meet regulatory or legal requirements, needs to dispose of an asset immediately to create liquidity or the existence of a single potential buyer as a result of the legal or time restrictions imposed). Accordingly, valuations are developed based on level 2 and level 3 inputs. Under such circumstances, entities may have:

    - A valuation policy that includes a process for determining whether level 1 inputs are available;

    - An understanding of how particular prices or inputs from external sources used as inputs to valuation techniques were calculated in order to assess their reliability. For example, in an active market, a broker quote on a financial instrument that has not traded is likely to reflect actual transactions on a similar financial instrument, but, as the market becomes less active, the broker quote may rely more on proprietary valuation techniques to determine prices;

    - An understanding of how deteriorating business conditions affect the counterparty, as well as whether deteriorating business conditions in entities similar to the counterparty may indicate that the counterparty may not fulfill its obligations (that is, non-performance risk);

- Policies for adjusting for measurement uncertainties. Such adjustments can include model adjustments, lack of liquidity adjustments, credit risk adjustments, and other risk adjustments;
- The capability to calculate the range of realistic outcomes given the uncertainties involved, for example by performing a sensitivity analysis; and
- Policies for identifying when a fair value measurement input moves to a different level of the fair value hierarchy.

42. Particular difficulties may develop where there is severe curtailment or even cessation of trading in particular financial instruments. In these circumstances, financial instruments that have previously been valued using market prices may need to be valued using a model.

Management's Valuation Process

43. Techniques that management may use to value their financial instruments include observable prices, recent transactions, and models that use observable or unobservable inputs. Management may also make use of:

    (a) A third-party pricing source, such as a pricing service or broker quote; or

    (b) A valuation expert.

    Third-party pricing sources and valuation experts may use one or more of these valuation techniques.

44. In many financial reporting frameworks, the best evidence of a financial instrument's fair value is found in contemporaneous transactions in an active market (that is, level 1 inputs). In such cases, the valuation of a financial instrument may be relatively simple. Quoted prices for financial instruments that are listed on exchanges or traded in liquid over-the-counter markets may be available from sources such as financial publications, the exchanges themselves or third-party pricing sources. When using quoted prices, it is important that management understand the basis on which the quote is given to ensure that the price reflects market conditions at the measurement date. Quoted prices obtained from publications or exchanges may provide sufficient evidence of fair value when, for example:

    (a) The prices are not out of date or "stale" (for example, if the quote is based on the last traded price and the trade occurred some time ago); and

    (b) The quotes are prices at which dealers would actually trade the financial instrument with sufficient frequency and volume.

45. Where there is no current observable market price for the financial instrument (that is, a level 1 input), it will be necessary for the entity to gather other price indicators to use in a valuation technique to value the financial instrument. Price indicators may include:

    - Recent transactions, including transactions after the date of the financial statements in the same instrument. Consideration is given to whether an adjustment needs to be made for changes in market conditions between the measurement date and the date the transaction was made, as these transactions are not necessarily indicative of the market conditions that existed at the date of the financial statements. In addition it is possible that the transaction represents a forced transaction and is therefore not indicative of a price in an orderly trade.

- Current or recent transactions in similar instruments, often known as "proxy pricing." Adjustments will need to be made to the price of the proxy to reflect the differences between them and the instrument being priced, for example, to take account of differences in liquidity or credit risk between the two instruments.

- Indices for similar instruments. As with transactions in similar instruments, adjustments will need to be made to reflect the difference between the instrument being priced and the instrument(s) from which the index used is derived.

46. It is expected that management will document its valuation policies and model used to value a particular financial instrument, including the rationale for the model(s) used, the selection of assumptions in the valuation methodology, and the entity's consideration of whether adjustments for measurement uncertainty are necessary.

Models

47. Models may be used to value financial instruments when the price cannot be directly observed in the market. Models can be as simple as a commonly used bond pricing formula or involve complex, specifically developed software tools to value financial instruments with level 3 inputs. Many models are based on discounted cash flow calculations.

48. Models comprise a methodology, assumptions and data. The methodology describes rules or principles governing the relationship between the variables in the valuation. Assumptions include estimates of uncertain variables which are used in the model. Data may comprise actual or hypothetical information about the financial instrument, or other inputs to the financial instrument.

49. Depending on the circumstances, matters that the entity may address when establishing or validating a model for a financial instrument include whether:

    - The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:

        - The methodology's theoretical soundness and mathematical integrity, including the appropriateness of parameters and sensitivities.

        - The consistency and completeness of the model's inputs with market practices, and whether the appropriate inputs are available for use in the model.

    - There are appropriate change control policies, procedures and security controls over the model.

    - The model is appropriately changed or adjusted on a timely basis for changes in market conditions.

    - The model is periodically calibrated, reviewed and tested for validity by a separate and objective function. Doing so is a means of ensuring that the model's output is a fair representation of the value that marketplace participants would ascribe to a financial instrument.

    - The model maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs.

    - Adjustments are made to the output of the model to reflect the assumptions marketplace participants would use in similar circumstances.

- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required data, results of any validation analysis performed and any adjustments made to the output of the model.

An Example of a Common Financial Instrument

50. The following describes how models may be applied to value a common financial instrument, known as an asset backed security.[9] Because asset backed securities are often valued based on level 2 or 3 inputs, they are frequently valued using models and involve:

    - Understanding the type of security—considering (a) the underlying collateral; and (b) the terms of the security. The underlying collateral is used to estimate the timing and amounts of cash flows such as mortgage or credit card interest and principal payments.

    - Understanding the terms of the security—this includes evaluating contractual cash flow rights, such as the order of repayment, and any default events. The order of repayment, often known as seniority, refers to terms which require that some classes of security holders (senior debt) are repaid before others (subordinated debt). The rights of each class of security holder to the cash flows, frequently referred to as the cash flow "waterfall," together with assumptions of the timing and amount of cash flows are used to derive a set of estimated cash flows for each class of security holder. The expected cash flows are then discounted to derive an estimated fair value.

51. The cash flows of an asset backed security may be affected by prepayments of the underlying collateral and by potential default risk and resulting estimated loss severities. Prepayment assumptions, if applicable, are generally based on evaluating market interest rates for similar collateral to the rates on the collateral underlying the security. For example, if market interest rates for mortgages have declined then the underlying mortgages in a security may experience higher prepayment rates than originally expected. Estimating potential default and loss severity involves close evaluation of the underlying collateral and borrowers to estimate default rates. For example, when the underlying collateral comprises residential mortgages, loss severities may be affected by estimates of residential housing prices over the term of the security.

Third-Party Pricing Sources

52. Entities may use third-party pricing sources in order to obtain fair value information. The preparation of an entity's financial statements, including the valuation of financial instruments and the preparation of financial statement disclosures relating to these instruments, may require expertise that management does not possess. Entities may not be able to develop appropriate valuation techniques, including models that may be used in a valuation, and may use a third-party pricing source to arrive at a valuation or to provide disclosures for the financial statements. This may particularly be the case in smaller entities or in entities that do not engage in a high volume of financial instruments transactions (for example, non-financial institutions with treasury departments). Even though management has used a third-party pricing source, management is ultimately responsible for the valuation.

53. Third-party pricing sources may also be used because the volume of securities to price over a short timeframe may not be possible by the entity. This is often the case for traded investment funds that must determine a net asset value each day. In other cases, management may have their own pricing process but use third-party pricing sources to corroborate their own valuations.

[9] An asset backed security is a financial instrument which is backed by a pool of underlying assets (known as the collateral, such as credit card receivables or vehicle loans) and derives value and income from those underlying assets.

54. For one or more of these reasons most entities use third-party pricing sources when valuing securities either as a primary source or as a source of corroboration for their own valuations. Third-party pricing sources generally fall into the following categories:

- Pricing services, including consensus pricing services; and

- Brokers proving broker quotes.

Pricing services

55. Pricing services provide entities with prices and price-related data for a variety of financial instruments, often performing daily valuations of large numbers of financial instruments. These valuations may be made by collecting market data and prices from a wide variety of sources, including market makers, and, in certain instances, using internal valuations techniques to derive estimated fair values. Pricing services may combine a number of approaches to arrive at a price. Pricing services are often used as a source of prices based on level 2 inputs. Pricing services may have strong controls around how prices are developed and their customers often include a wide variety of parties, including buy and sell side investors, back and middle office functions, auditors and others.

56. Pricing services often have a formalized process for customers to challenge the prices received from the pricing services. These challenge processes usually require the customer to provide evidence to support an alternative price, with challenges categorized based on the quality of evidence provided. For example, a challenge based on a recent sale of that instrument that the pricing service was not aware of may be upheld, whereas a challenge based on a customer's own valuation technique may be more heavily scrutinized. In this way, a pricing service with a large number of leading participants, both buy and sell side, may be able to constantly correct prices to more fully reflect the information available to market participants.

Consensus pricing services

57. Some entities may use pricing data from consensus pricing services which differ from other pricing services. Consensus pricing services obtain pricing information about an instrument from several participating entities (subscribers). Each subscriber submits prices to the pricing service. The pricing service treats this information confidentially and returns to each subscriber the consensus price, which is usually an arithmetical average of the data after a data cleansing routine has been employed to eliminate outliers. For some markets, such as for exotic derivatives, consensus prices might constitute the best available data. However, many factors are considered when assessing the representational faithfulness of the consensus prices including, for example:

- Whether the prices submitted by the subscribers reflect actual transactions or just indicative prices based on their own valuation techniques.

- The number of sources from which prices have been obtained.

- The quality of the sources used by the consensus pricing service.

- Whether participants include leading market participants

58. Typically consensus prices are only available to subscribers who have submitted their own prices to the service. Accordingly not all entities will have direct access to consensus prices. Because a subscriber generally cannot know how the prices submitted were estimated, other sources of evidence in addition to information from consensus pricing services may be needed for management to support their valuation. In particular, this may be the case if the sources are providing indicative prices based on their own valuation techniques and management is unable to obtain an understanding of how these sources calculated their prices.

Brokers providing broker quotes

59. As brokers provide quotes only as an incidental service for their clients, quotes they provide differ in many respects from prices obtained in pricing services. Brokers may be unwilling to provide information about the process used to develop their quote, but may have access to information on transactions about which a pricing service may not be aware. Broker quotes may be executable or indicative. Indicative quotes are a broker's best estimate of fair value, whereas an executable quote shows that the broker is willing to transact at this price. Executable quotes are strong evidence of fair value. Indicative quotes are less so because of the lack of transparency into the methods used by the broker to establish the quote. In addition the rigor of controls over the brokers' quote often will differ depending on whether the broker also holds the same security in its own portfolio. Broker quotes are often used for securities with level 3 inputs and sometimes may be the only external information available.

Further considerations relating to third-party pricing sources

60. Understanding how the pricing sources calculated a price enables management to determine whether such information is suitable for use in its valuation, including as an input to a valuation technique and in what level of inputs the security should be categorized for disclosure purposes. For example, third-party pricing sources may value financial instruments using proprietary models, and it is important that management understands the methodology, assumptions and data used.

61. If fair value measurements obtained from third-party pricing sources are not based on the current prices of an active market, it will be necessary for management to evaluate whether the fair value measurements were derived in a manner that is consistent with the applicable financial reporting framework. Management's understanding of the fair value measurement includes:

- How the fair value measurement was determined—for example, whether the fair value measurement was determined by a valuation technique, in order to assess whether it is consistent with the fair value measurement objective;
- Whether the quotes are indicative prices, indicative spread, or binding offers; and
- How frequently the fair value measurement is estimated by the third-party pricing sources—in order to assess whether it reflects market conditions at the measurement date.

Understanding the bases on which third-party pricing sources have determined their quotes in the context of the particular financial instruments held by the entity assists management in evaluating the relevance and reliability of this evidence to support its valuations.

62. It is possible that there will be disparities between price indicators from different sources. Understanding how the price indicators were derived, and investigating these disparities, assists management in corroborating the evidence used in developing its valuation of financial instruments in order to evaluate whether the valuation is reasonable. Simply taking the average of the quotes provided, without doing further research, may not be appropriate, because one price in the range may be the most representative of fair value and this may not be the average. To evaluate whether its valuations of financial instruments are reasonable, management may:

- Consider whether actual transactions represent forced transactions rather than transactions between willing buyers and willing sellers. This may invalidate the price as a comparison;
- Analyze the expected future cash flows of the instrument. This could be performed as an indicator of the most relevant pricing data;

- Depending on the nature of what is unobservable, extrapolate from observed prices to unobserved ones (for example, there may be observed prices for maturities up to ten years but not longer, but the ten year price curve may be capable of being extrapolated beyond ten years as an indicator). Care is needed to ensure that extrapolation is not carried so far beyond the observable curve that its link to observable prices becomes too tenuous to be reliable;

- Compare prices within a portfolio of financial instruments to each other to make sure that they are consistent among similar financial instruments;

- Use more than one model to corroborate the results from each one, having regard to the data and assumptions used in each; or

- Evaluate movements in the prices for related hedging instruments and collateral.

In coming to its judgment as to its valuation, an entity may also consider other factors that may be specific to the entity's circumstances.

Use of Valuation Experts

63. Management may engage a valuation expert from an investment bank, broker, or other valuation firm to value some or all of its securities. Unlike pricing services and broker quotes, generally the methodology and data used are more readily available to management when they have engaged an expert to perform a valuation on their behalf. Even though management has engaged an expert, management is ultimately responsible for the valuation used.

Issues Related to Financial Liabilities

64. Understanding the effect of credit risk is an important aspect of valuing both financial assets and financial liabilities. This valuation reflects the credit quality and financial strength of both the issuer and any credit support providers. In some financial reporting frameworks, the measurement of a financial liability assumes that it is transferred to a market participant at the measurement date. Where there is not an observable market price for a financial liability, its value is typically measured using the same method as a counterparty would use to measure the value of the corresponding asset, unless there are factors specific to the liability (such as third-party credit enhancement). In particular, the entity's own credit risk[10] can often be difficult to measure.

Presentation and Disclosure about Financial Instruments

65. Most financial reporting frameworks require disclosures in the financial statements to enable users of the financial statements to make meaningful assessments of the effects of the entity's financial instrument activities, including the risks and uncertainties associated with financial instruments.

66. Most frameworks require the disclosure of quantitative and qualitative information (including accounting policies) relating to financial instruments. The accounting requirements for fair value measurements in financial statement presentation and disclosures are extensive in most financial reporting frameworks and encompass more than just valuation of the financial instruments. For example, qualitative disclosures about financial instruments provide important contextual information about the characteristics of the financial instruments and their future cash flows that may help inform investors about the risks to which entities are exposed.

[10] Own credit risk is the amount of change in fair value that is not attributable to changes in market conditions.

Categories of Disclosures

67. Disclosure requirements include:

   (a) Quantitative disclosures that are derived from the amounts included in the financial statements—for example, categories of financial assets and liabilities;

   (b) Quantitative disclosures that require significant judgment—for example, sensitivity analysis for each type of market risk to which the entity is exposed; and

   (c) Qualitative disclosures—for example, those that describe the entity's governance over financial instruments; objectives; controls, policies and processes for managing each type of risk arising from financial instruments; and the methods used to measure the risks.

68. The more sensitive the valuation is to movements in a particular variable, the more likely it is that disclosure will be necessary to indicate the uncertainties surrounding the valuation. Certain financial reporting frameworks may also require disclosure of sensitivity analyses, including the effects of changes in assumptions used in the entity's valuation techniques. For example, the additional disclosures required for financial instruments with fair value measurements that are categorized within level 3 inputs of the fair value hierarchy are aimed at informing users of financial statements about the effects of those fair value measurements that use the most subjective inputs.

69. Some financial reporting frameworks require disclosure of information that enables users of the financial statements to evaluate the nature and extent of the risks arising from financial instruments to which the entity is exposed at the reporting date. This disclosure may be contained in the notes to the financial statements, or in management's discussion and analysis within its annual report cross-referenced from the audited financial statements. The extent of disclosure depends on the extent of the entity's exposure to risks arising from financial instruments. This includes qualitative disclosures about:

   - The exposures to risk and how they arise, including the possible effects on an entity's future liquidity and collateral requirements;
   - The entity's objectives, policies and processes for managing the risk and the methods used to measure the risk; and
   - Any changes in exposures to risk or objectives, policies or processes for managing risk from the previous period.

Section II—Audit Considerations Relating to Financial Instruments

70. Certain factors may make auditing financial instruments particularly challenging. For example:

   - It may be difficult for both management and the auditor to understand the nature of financial instruments and what they are used for, and the risks to which the entity is exposed.
   - Market sentiment and liquidity can change quickly, placing pressure on management to manage their exposures effectively.
   - Evidence supporting valuation may be difficult to obtain.
   - Individual payments associated with certain financial instruments may be significant, which may increase the risk of misappropriation of assets.

- The amounts recorded in the financial statements relating to financial instruments may not be significant, but there may be significant risks and exposures associated with these financial instruments.

- A few employees may exert significant influence on the entity's financial instruments transactions, in particular where their compensation arrangements are tied to revenue from financial instruments, and there may be possible undue reliance on these individuals by others within the entity.

These factors may cause risks and relevant facts to be obscured, which may affect the auditor's assessment of the risks of material misstatement, and latent risks can emerge rapidly, especially in adverse market conditions.

Professional Skepticism[11]

71. Professional skepticism is necessary to the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes questioning contradictory audit evidence and the reliability of documents, responses to inquiries and other information obtained from management and those charged with governance. It also includes being alert to conditions that may indicate possible misstatement due to error or fraud and considering the sufficiency and appropriateness of audit evidence obtained in light of the circumstances.

72. Application of professional skepticism is required in all circumstances, and the need for professional skepticism increases with the complexity of financial instruments, for example with regard to:

    - Evaluating whether sufficient appropriate audit evidence has been obtained, which can be particularly challenging when models are used or in determining if markets are inactive.

    - Evaluating management's judgments, and the potential for management bias, in applying the entity's applicable financial reporting framework, in particular management's choice of valuation techniques, use of assumptions in valuation techniques, and addressing circumstances in which the auditor's judgments and management's judgments differ.

    - Drawing conclusions based on the audit evidence obtained, for example assessing the reasonableness of valuations prepared by management's experts and evaluating whether disclosures in the financial statements achieve fair presentation.

Planning Considerations[12]

73. The auditor's focus in planning the audit is particularly on:

    - Understanding the accounting and disclosure requirements;

    - Understanding the financial instruments to which the entity is exposed, and their purpose and risks;

    - Determining whether specialized skills and knowledge are needed in the audit;

11 HKSA 200, paragraph 15

12 HKSA 300, *Planning an Audit of Financial Statements*, deals with the auditor's responsibility to plan an audit of financial statements.

- Understanding and evaluating the system of internal control in light of the entity's financial instrument transactions and the information systems that fall within the scope of the audit;

- Understanding the nature, role and activities of the internal audit function;

- Understanding management's process for valuing financial instruments, including whether management has used an expert or a service organization; and

- Assessing and responding to the risk of material misstatement.

Understanding the Accounting and Disclosure Requirements

74. HKSA 540 requires the auditor to obtain an understanding of the requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures and any regulatory requirements.[13] The requirements of the applicable financial reporting framework regarding financial instruments may themselves be complex and require extensive disclosures. Reading this HKAPG is not a substitute for a full understanding of all the requirements of the applicable financial reporting framework. Certain financial reporting frameworks require consideration of areas such as:

    - Hedge accounting;

    - Accounting for "Day 1" profits or losses;

    - Recognition and derecognition of financial instrument transactions;

    - Own credit risk; and

    - Risk transfer and derecognition, in particular where the entity has been involved in the origination and structuring of complex financial instruments.

Understanding the Financial Instruments

75. The characteristics of financial instruments may obscure certain elements of risk and exposure. Obtaining an understanding of the instruments in which the entity has invested or to which it is exposed, including the characteristics of the instruments, helps the auditor to identify whether:

    - Important aspects of a transaction are missing or inaccurately recorded;

    - A valuation appears appropriate;

    - The risks inherent in them are fully understood and managed by the entity; and

    - The financial instruments are appropriately classified into current and non-current assets and liabilities.

76. Examples of matters that the auditor may consider when obtaining an understanding of the entity's financial instruments include:

    - To which types of financial instruments the entity is exposed.

    - The use to which they are put.

13 HKSA 540, paragraph 8(a)

- Management's and, where appropriate, those charged with governance's understanding of the financial instruments, their use and the accounting requirements.

- Their exact terms and characteristics so that their implications can be fully understood and, in particular where transactions are linked, the overall impact of the financial instrument transactions.

- How they fit into the entity's overall risk management strategy.

Inquiries of the internal audit function, the risk management function, if such functions exist, and discussions with those charged with governance may inform the auditor's understanding.

77. In some cases, a contract, including a contract for a non-financial instrument may contain a derivative. Some financial reporting frameworks permit or require such "embedded" derivatives to be separated from the host contract in some circumstances. Understanding management's process for identifying, and accounting for, embedded derivatives will assist the auditor in understanding the risks to which the entity is exposed.

Using Those with Specialized Skills and Knowledge in the Audit[14]

78. A key consideration in audits involving financial instruments, particularly complex financial instruments, is the competence of the auditor. HKSA 220[15] requires the engagement partner to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements and to enable an auditor's report that is appropriate in the circumstances to be issued. Further, relevant ethical requirements [16] require the auditor to determine whether acceptance of the engagement would create any threats to compliance with the fundamental principles, including the professional competence and due care. Paragraph 79 below provides examples of the types of matters that may be relevant to the auditor's considerations in the context of financial instruments.

79. Accordingly, auditing financial instruments may require the involvement of one or more experts or specialists, for example, in the areas of:

- Understanding the financial instruments used by the entity and their characteristics, including their level of complexity. Using specialized skills and knowledge may be needed in checking whether all aspects of the financial instrument and related considerations have been captured in the financial statements, and evaluating whether adequate disclosure in accordance with the applicable financial reporting framework has been made where disclosure of risks is required.

- Understanding the applicable financial reporting framework, especially when there are areas known to be subject to differing interpretations, or practice is inconsistent or developing.

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14 When such a person's expertise is in auditing and accounting, regardless of whether the person is from within or external to the firm, this person is considered to be part of the engagement team and is subject to the requirements of HKSA 220, *Quality Control for an Audit of Financial Statements*. When such a person's expertise is in a field other than accounting or auditing, such person is considered to be an auditor's expert, and the provisions of HKSA 620, *Using the Work of an Auditor's Expert*, apply. HKSA 620 explains that distinguishing between specialized areas of accounting or auditing, and expertise in another field, will be a matter of professional judgment, but notes the distinction may be made between expertise in methods of accounting for financial instruments (accounting and auditing expertise) and expertise in complex valuation techniques for financial instruments (expertise in a field other than accounting or auditing).

15 HKSA 220, paragraph 14

16 The *Code of Ethics for Professional Accountants* paragraphs 210.1 and 210.6

- Understanding the legal, regulatory, and tax implications resulting from the financial instruments, including whether the contracts are enforceable by the entity (for example, reviewing the underlying contracts), may require specialized skills and knowledge.

- Assessing the risks inherent in a financial instrument.

- Assisting the engagement team gather evidence to support management's valuations or to develop a point estimate or range, especially when fair value is determined by a complex model; when markets are inactive and data and assumptions are difficult to obtain; when unobservable inputs are used; or when management has used an expert.

- Evaluating information technology controls, especially in entities with a high volume of financial instruments. In such entities information technology may be highly complex, for example when significant information about those financial instruments is transmitted, processed, maintained or accessed electronically. In addition, it may include relevant services provided by a service organization.

80. The nature and use of particular types of financial instruments, the complexities associated with accounting requirements, and market conditions may lead to a need for the engagement team to consult[17] with other accounting and audit professionals, from within or outside the firm, with relevant technical accounting or auditing expertise and experience, taking into account factors such as:

- The capabilities and competence of the engagement team, including the experience of the members of the engagement team.

- The attributes of the financial instruments used by the entity.

- The identification of unusual circumstances or risks in the engagement, as well as the need for professional judgment, particularly with respect to materiality and significant risks.

- Market conditions.

Understanding Internal Control

81. HKSA 315 establishes requirements for the auditor to understand the entity and its environment, including its internal control. Obtaining an understanding of the entity and its environment, including the entity's internal control, is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding obtained enables the auditor to identify and assess the risks of material misstatement at the financial statement and assertion levels, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement. The volume and variety of the financial instrument transactions of an entity typically determines the nature and extent of controls that may exist at an entity. An understanding of how financial instruments are monitored and controlled assists the auditor in determining the nature, timing and extent of audit procedures. The Appendix describes controls that may exist in an entity that deals in a high volume of financial instrument transactions.

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[17] HKSA 220, paragraph 18(b), requires the engagement partner to be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm.

Understanding the Nature, Role and Activities of the Internal Audit Function

82. In many large entities, the internal audit function may perform work that enables senior management and those charged with governance to review and evaluate the entity's controls relating to the use of financial instruments. The internal audit function may assist in identifying the risks of material misstatement due to fraud or error. However, the knowledge and skills required of an internal audit function to understand and perform procedures to provide assurance to management or those charged with governance on the entity's use of financial instruments are generally quite different from those needed for other parts of the business. The extent to which the internal audit function has the knowledge and skill to cover, and has in fact covered, the entity's financial instrument activities, as well as the competence and objectivity of the internal audit function, is a relevant consideration in the external auditor's determination of whether the internal audit function is likely to be relevant to the overall audit strategy and audit plan.

83. Areas where the work of the internal audit function may be particularly relevant are:[18]

- Developing a general overview of the extent of use of financial instruments;
- Evaluating the appropriateness of policies and procedures and management's compliance with them;
- Evaluating the operating effectiveness of financial instrument control activities;
- Evaluating systems relevant to financial instrument activities; and
- Assessing whether new risks relating to financial instruments are identified, assessed and managed.

Understanding Management's Methodology for Valuing Financial Instruments

84. Management's responsibility for the preparation of the financial statements includes applying the requirements of the applicable financial reporting framework to the valuation of financial instruments. HKSA 540 requires the auditor to obtain an understanding of how management makes accounting estimates and the data on which accounting estimates are based.[19] Management's approach to valuation also takes into account the selection of an appropriate valuation methodology and the level of the evidence expected to be available. To meet the objective of a fair value measurement, an entity develops a valuation methodology to measure the fair value of financial instruments that considers all relevant market information that is available. A thorough understanding of the financial instrument being valued allows an entity to identify and evaluate the relevant market information available about identical or similar instruments that should be incorporated into the valuation methodology.

Assessing and Responding to the Risks of Material Misstatement

Overall Considerations Relating to Financial Instruments

85. HKSA 540[20] explains that the degree of estimation uncertainty affects the risk of material misstatement of accounting estimates. The use of more complex financial instruments, such as those that have a high level of uncertainty and variability of future cash flows, may lead to an increased risk of material misstatement, particularly regarding valuation. Other matters affecting the risk of material misstatement include:

[18] Work performed by functions such as the risk management function, model review functions, and product control, may also be relevant.

[19] HKSA 540, paragraph 8(c)

[20] HKSA 540, paragraph 2

- The volume of financial instruments to which the entity is exposed.
- The terms of the financial instrument, including whether the financial instrument itself includes other financial instruments.
- The nature of the financial instruments.

Fraud Risk Factors[21]

86. Incentives for fraudulent financial reporting by employees may exist where compensation schemes are dependent on returns made from the use of financial instruments. Understanding how an entity's compensation policies interact with its risk appetite, and the incentives that this may create for its management and traders, may be important in assessing the risk of fraud.

87. Difficult financial market conditions may give rise to increased incentives for management or employees to engage in fraudulent financial reporting: to protect personal bonuses, to hide employee or management fraud or error, to avoid breaching regulatory, liquidity or borrowing limits or to avoid reporting losses. For example, at times of market instability, unexpected losses may arise from extreme fluctuations in market prices, from unanticipated weakness in asset prices, through trading misjudgments, or for other reasons. In addition, financing difficulties create pressures on management concerned about the solvency of the business.

88. Misappropriation of assets and fraudulent financial reporting may often involve override of controls that otherwise may appear to be operating effectively. This may include override of controls over data, assumptions and detailed process controls that allow losses and theft to be hidden. For example, difficult market conditions may increase pressure to conceal or offset trades as they attempt to recover losses.

Assessing the Risk of Material Misstatement

89. The auditor's assessment of the identified risks at the assertion level in accordance with HKSA 315 includes evaluating the design and implementation of internal control. It provides a basis for considering the appropriate audit approach for designing and performing further audit procedures in accordance with HKSA 330, including both substantive procedures and tests of controls. The approach taken is influenced by the auditor's understanding of internal control relevant to the audit, including the strength of the control environment and any risk management function, the size and complexity of the entity's operations and whether the auditor's assessment of the risks of material misstatement include an expectation that controls are operating effectively.

90. The auditor's assessment of the risk of material misstatement at the assertion level may change during the course of the audit as additional information is obtained. Remaining alert during the audit, for example, when inspecting records or documents may assist the auditor in identifying arrangements or other information that may indicate the existence of financial instruments that management has not previously identified or disclosed to the auditor. Such records and documents may include, for example:

    - Minutes of meetings of those charged with governance; and
    - Specific invoices from, and correspondence with, the entity's professional advisors.

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21 See HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, for requirements and guidance dealing with fraud risk factors.

Factors to Consider in Determining Whether, and to What Extent, to Test the Operating Effectiveness of Controls

91. An expectation that controls are operating effectively may be more common when dealing with a financial institution with well-established controls, and therefore controls testing may be an effective means of obtaining audit evidence. When an entity has a trading function, substantive tests alone may not provide sufficient appropriate audit evidence due to the volume of contracts and the different systems used. Tests of controls, however, will not be sufficient on their own as the auditor is required by HKSA 330 to design and perform substantive procedures for each material class of transactions, account balance and disclosure.[22]

92. Entities with a high volume of trading and use of financial instruments may have more sophisticated controls, and an effective risk management function, and therefore the auditor may be more likely to test controls in obtaining evidence about:

- The occurrence, completeness, accuracy, and cutoff of the transactions; and
- The existence, rights and obligations, and completeness of account balances.

93. In those entities with relatively few financial instrument transactions:

- Management and those charged with governance may have only a limited understanding of financial instruments and how they affect the business;
- The entity may only have a few different types of instruments with little or no interaction between them;
- There is unlikely to be a complex control environment (for example, the controls described in the Appendix may not be in place at the entity);
- Management may use pricing information from third-party pricing sources to value their instruments; and
- Controls over the use of pricing information from third-party pricing sources may be less sophisticated.

94. When an entity has relatively few transactions involving financial instruments, it may be relatively easy for the auditor to obtain an understanding of the entity's objectives for using the financial instruments and the characteristics of the instruments. In such circumstances, much of the audit evidence is likely to be substantive in nature, the auditor may perform the majority of the audit work at year-end, and third-party confirmations are likely to provide evidence in relation to the completeness, accuracy, and existence of the transactions.

95. In reaching a decision on the nature, timing and extent of testing of controls, the auditor may consider factors such as:

- The nature, frequency and volume of financial instrument transactions;
- The strength of controls, including whether controls are appropriately designed to respond to the risks associated with an entity's volume of financial instrument transactions and whether there is a governance framework over the entity's financial instrument activities;

[22] HKSA 330, paragraph 18

- The importance of particular controls to the overall control objectives and processes in place at the entity, including the sophistication of the information systems to support financial instrument transactions;

- The monitoring of controls and identified deficiencies in control procedures;

- The issues the controls are intended to address, for example, controls related to the exercise of judgments compared with controls over supporting data. Substantive tests are more likely to be effective than relying on controls related to the exercise of judgment;

- The competency of those involved in the control activities, for example whether the entity has adequate capacity, including during periods of stress, and ability to establish and verify valuations for the financial instruments to which it is exposed;

- The frequency of performance of these control activities;

- The level of precision the controls are intended to achieve;

- The evidence of performance of control activities; and

- The timing of key financial instrument transactions, for example, whether they are close to the period end.

Substantive Procedures

96. Designing substantive procedures includes consideration of:

    - The use of analytical procedures[23]—While analytical procedures undertaken by the auditor can be effective as risk assessment procedures to provide the auditor with information about an entity's business, they may be less effective as substantive procedures when performed alone. This is because the complex interplay of the drivers of the valuation often mask any unusual trends that might arise.

    - Non-routine transactions—Many financial transactions are negotiated contracts between an entity and its counterparty (often known as "over the counter" or OTC.) To the extent that financial instrument transactions are not routine and outside an entity's normal activities, a substantive audit approach may be the most effective means of achieving the planned audit objectives. In instances where financial instrument transactions are not undertaken routinely, the auditor's responses to assessed risk, including designing and performing audit procedures, have regard to the entity's possible lack of experience in this area.

    - Availability of evidence—For example, when the entity uses a third-party pricing source, evidence concerning the relevant financial statement assertions may not be available from the entity.

    - Procedures performed in other audit areas—Procedures performed in other financial statement areas may provide evidence about the completeness of financial instrument transactions. These procedures may include tests of subsequent cash receipts and payments, and the search for unrecorded liabilities.

[23] HKSA 315, paragraph 6(b), requires the auditor to apply analytical procedures as risk assessment procedures to assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. HKSA 520, *Analytical Procedures*, paragraph 6, requires the auditor to use analytical procedures in forming an overall conclusion on the financial statements. Analytical procedures may also be applied at other stages of the audit.

- Selection of items for testing—In some cases, the financial instrument portfolio will comprise instruments with varying complexity and risk. In such cases, judgmental sampling may be useful.

97. For example, in the case of an asset-backed security, in responding to the risks of material misstatement for such a security, the auditor may consider performing some of the following audit procedures:

    - Examining contractual documentation to understand the terms of the security, the underlying collateral and the rights of each class of security holder.
    - Inquiring about management's process of estimating cash flows.
    - Evaluating the reasonableness of assumptions, such as prepayment rates, default rates and loss severities.
    - Obtaining an understanding of the method used to determine the cash flow waterfall.
    - Comparing the results of the fair value measurement with the valuations of other securities with similar underlying collateral and terms.
    - Reperforming calculations.

Dual-Purpose Tests

98. Although the purpose of a test of controls is different from the purpose of a test of details, it may be efficient to perform both at the same time by, for example:

    - Performing a test of controls and a test of details on the same transaction (for example, testing whether a signed contract has been maintained and whether the details of the financial instrument have been appropriately captured in a summary sheet; or
    - Testing controls when testing management's process of making valuation estimates.

Timing of the Auditor's Procedures[24]

99. After assessing the risks associated with financial instruments, the engagement team determines the timing of planned tests of controls and substantive audit procedures. The timing of planned audit procedures varies depending on a number of factors, including the frequency of the control operation, the significance of the activity being controlled, and the related risk of material misstatement.

100. While it is necessary to undertake most of the audit procedures in relation to valuation and presentation at the period end, audit procedures in relation to other assertions such as completeness and existence can usefully be tested at an interim period. For example tests of controls may be performed at an interim period for more routine controls, such as IT controls and authorizations for new products. Also, it may be effective to test the operating effectiveness of controls over new product approval by gathering evidence of the appropriate level of management sign-off on a new financial instrument for an interim period.

101. Auditors may perform some tests on models as of an interim date, for example, by comparing the output of the model to market transactions. Another possible interim procedure for instruments with observable inputs is to test the reasonableness of the pricing information provided by a third-party pricing source.

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[24] Paragraphs 11–12 and 22–23 of HKSA 330 establish requirements when the auditor performs procedures at an interim period and explains how such audit evidence can be used.

102. Areas of more significant judgment are often tested close to, or at, the period end as:

- Valuations can change significantly in a short period of time, making it difficult to compare and reconcile interim balances with comparable information at the balance sheet date;
- An entity may engage in an increased volume of financial instrument transactions between an interim period and year-end;
- Manual journal entries may only be made after the end of the accounting period; and
- Non-routine or significant transactions may take place late in the accounting period.

Procedures Relating to Completeness, Accuracy, Existence, Occurrence and Rights and Obligations

103. Many of the auditor's procedures can be used to address a number of assertions. For example, procedures to address the existence of an account balance at period end will also address the occurrence of a class of transactions, and may also assist in establishing proper cut-off. This is because financial instruments arise from legal contracts and, by verifying the accuracy of the recording of the transaction, the auditor can also verify its existence, and obtain evidence to support the occurrence and rights and obligations assertions at the same time, and confirm that transactions are recorded in the correct accounting period.

104. Procedures that may provide audit evidence to support the completeness, accuracy, and existence assertions include:

- External confirmation[25] of bank accounts, trades, and custodian statements. This can be done by direct confirmation with the counterparty (including the use of bank confirmations), where a reply is sent to the auditor directly. Alternatively this information may be obtained from the counterparty's systems through a data feed. Where this is done, controls to prevent tampering with the computer systems through which the information is transmitted may be considered by the auditor in evaluating the reliability of the evidence from the confirmation. If confirmations are not received, the auditor may be able to obtain evidence by reviewing contracts and testing relevant controls. External confirmations, however, often do not provide adequate audit evidence with respect to the valuation assertion though they may assist in identifying any side agreements.
- Reviewing reconciliations of statements or data feeds from custodians with the entity's own records. This may necessitate evaluating IT controls around and within automated reconciliation processes and to evaluate whether reconciling items are properly understood and resolved.
- Reviewing journal entries and the controls over the recording of such entries. This may assist in, for example:
  - Determining if entries have been made by employees other than those authorized to do so.
  - Identifying unusual or inappropriate end-of-period journal entries, which may be relevant to fraud risk.
- Reading individual contracts and reviewing supporting documentation of the entity's financial instrument transactions, including accounting records, thereby verifying existence

[25] HKSA 505, *External Confirmations*, deals with the auditor's use of external confirmation procedures to obtain audit evidence in accordance with the requirements of HKSA 330 and HKSA 500, *Audit Evidence*.

and rights and obligations. For example, an auditor may read individual contracts associated with financial instruments and review supporting documentation, including the accounting entries made when the contract was initially recorded, and may also subsequently review accounting entries made for valuation purposes. Doing so allows the auditor to evaluate whether the complexities inherent in a transaction have been fully identified and reflected in the accounts. Legal arrangements and their associated risks need to be considered by those with suitable expertise to ensure that rights exist.

- Testing controls, for example by reperforming controls.
- Reviewing the entity's complaints management systems. Unrecorded transactions may result in the entity's failure to make a cash payment to a counterparty, and may be detected by reviewing complaints received.
- Reviewing master netting arrangements to identify unrecorded instruments.

105. These procedures are particularly important for some financial instruments, such as derivatives or guarantees. This is because they may not have a large initial investment, meaning it may be hard to identify their existence. For example, embedded derivatives are often contained in contracts for non-financial instruments which may not be included in confirmation procedures.

Valuation of Financial Instruments

Financial Reporting Requirements

106. Fair presentation financial reporting frameworks often use fair value hierarchies, for example those used in IFRS, HKFRS and U.S. GAAP. This usually means that the volume and detail of the required disclosures increases as the level of measurement uncertainty increases. The distinction between the levels in the hierarchy may require judgment.

107. The auditor may find it useful to obtain an understanding of how the financial instruments relate to the fair value hierarchy. Ordinarily, the risk of material misstatement, and the level of audit procedures to be applied, increases as the level of measurement uncertainty increases. The use of level 3, and some level 2, inputs from the fair value hierarchy may be a useful guide to the level of measurement uncertainty. Level 2 inputs vary from those which are easily obtained to those which are closer to level 3 inputs. The auditor evaluates available evidence and understands both the fair value hierarchy and the risk of management bias in management's categorization of financial instruments in the fair value hierarchy.

108. In accordance with HKSA 540,[26] the auditor considers the entity's valuation policies and methodology for data and assumptions used in the valuation methodology. In many cases, the applicable financial reporting framework does not prescribe the valuation methodology. When this is the case, matters that may be relevant to the auditor's understanding of how management values financial instruments include, for example:

- Whether management has a formal valuation policy and, if so, whether the valuation technique used for a financial instrument is appropriately documented in accordance with that policy;
- Which models may give rise to the greatest risk of material misstatement;

[26] HKSA 540, paragraph 8(c)

- How management considered the complexity of the valuation of the financial instrument when selecting a particular valuation technique;
- Whether there is a greater risk of material misstatement because management has internally developed a model to be used to value financial instruments or is departing from a valuation technique commonly used to value the particular financial instrument;
- Whether management made use of a third-party pricing source;
- Whether those involved in developing and applying the valuation technique have the appropriate skills and expertise to do so, including whether a management's expert has been used; and
- Whether there are indicators of management bias in selecting the valuation technique to be used.

Assessing the Risk of Material Misstatement Related to Valuation

109. When evaluating whether the valuation techniques used by an entity are appropriate in the circumstances, and whether controls over valuation techniques are in place, the factors considered by the auditor may include:

- Whether the valuation techniques are commonly used by other market participants and have been previously demonstrated to provide a reliable estimate of prices obtained from market transactions;
- Whether the valuation techniques operate as intended and there are no flaws in their design, particularly under extreme conditions, and whether they have been objectively validated. Indicators of flaws include inconsistent movements relative to benchmarks;
- Whether the valuation techniques take account of the risks inherent in the financial instrument being valued, including counterparty creditworthiness, and own credit risk in the case of valuation techniques used to measure financial liabilities;
- How the valuation techniques are calibrated to the market, including the sensitivity of the valuation techniques to changes in variables;
- Whether market variables and assumptions are used consistently and whether new conditions justify a change in the valuation techniques, market variables or assumptions used;
- Whether sensitivity analyses indicate that valuations would change significantly with only small or moderate changes in assumptions;
- The organizational structure, such as the existence of an internal department responsible for developing models to value certain instruments, particularly where level 3 inputs are involved. For example, a model development function that is involved in assisting in pricing deals is less objective than one which is functionally and organizationally segregated from the front office; and
- The competence and objectivity of those responsible for the development and application of the valuation techniques, including management's relative experience with particular models that may be newly developed.

The auditor (or auditor's expert) may also independently develop one or more valuation techniques to compare its output with that of the valuation techniques used by management.

Significant Risks

110. The auditor's risk assessment process may lead the auditor to identify one or more significant risks relating to the valuation of financial instruments, when any of the following circumstances exist:

- High measurement uncertainty related to the valuation of financial instruments (for example, those with unobservable inputs).[27]
- Lack of sufficient evidence to support management's valuation of its financial instruments.
- Lack of management understanding of its financial instruments or expertise necessary to value such instruments properly, including the ability to determine whether valuation adjustments are needed.
- Lack of management understanding of complex requirements in the applicable financial reporting framework relating to measurement and disclosure of financial instruments, and inability of management to make the judgments required to properly apply those requirements.
- The significance of valuation adjustments made to valuation technique outputs when the applicable financial reporting framework requires or permits such adjustments.

111. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of HKSA 330, HKSA 540[28] requires the auditor to evaluate the following:

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed measurement uncertainty in making the accounting estimate;

(b) Whether the significant assumptions used by management are reasonable; and

(c) Where relevant to the reasonableness of the significant assumptions used by management, or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

112. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model, or may result in a change from one particular model to another. Reacting to changes in market conditions may be difficult if management does not have policies in place prior to their occurrence. Management may also not possess the expertise necessary to develop a model on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of financial instruments. Further, valuation techniques may have been selected in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.

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[27] Where the auditor determines that the high estimation uncertainty related to the valuation of complex financial instruments gives rise to a significant risk, HKSA 540 requires the auditor to perform substantive procedures and evaluate the adequacy of the disclosure of their estimation uncertainty. See HKSA 540, paragraphs 11, 15 and 20.

[28] HKSA 540, paragraph 15(a)-(b)

113. The susceptibility to management bias, whether intentional or unintentional, increases with the subjectivity of the valuation and the degree of measurement uncertainty. For example, management may tend to ignore observable marketplace assumptions or data and instead use their own internally-developed model if the model yields more favorable results. Even without fraudulent intent, there may be a natural temptation to bias judgments towards the most favorable end of what may be a wide spectrum, rather than the point in the spectrum that might be considered to be most consistent with the applicable financial reporting framework. Changing the valuation technique from period to period without a clear and appropriate reason for doing so may also be an indicator of management bias. Although some form of management bias is inherent in subjective decisions relating to the valuation of financial instruments, when there is intention to mislead, management bias is fraudulent in nature.

Developing an Audit Approach

114. In testing how management values the financial instrument and in responding to the assessed risks of material misstatement in accordance with HKSA 540,[29] the auditor undertakes one or more of the following procedures, taking account of the nature of the accounting estimates:

(a) Test how management made the accounting estimate and the data on which it is based (including valuation techniques used by the entity in its valuations).

(b) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

(c) Develop a point estimate or a range to evaluate management's point estimate.

(d) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.

Many auditors find that a combination of testing how management valued the financial instrument, and the data on which it is based, and testing the operating effectiveness of controls, will be an effective and efficient audit approach. While subsequent events may provide some evidence about the valuation of financial instruments, other factors may need to be taken into account to address any changes in market conditions subsequent to the balance sheet date.[30] If the auditor is unable to test how management made the estimate, the auditor may choose to develop a point estimate or range.

115. As described in Section I, to estimate the fair value of financial instruments management may:

- Utilize information from third-party pricing sources;
- Gather data to develop their own estimate using various techniques including models; and
- Engage an expert to develop an estimate.

Management often may use a combination of these approaches. For example, management may have their own pricing process but use third-party pricing sources to corroborate their own values.

[29] HKSA 540, paragraphs 12–14

[30] Paragraphs A63-A66 of HKSA 540 provide examples of some of the factors that may be relevant.

Audit Considerations When Management Uses a Third-Party Pricing Source

116. Management may make use of a third-party pricing source, such as a pricing service or broker, in valuing the entity's financial instruments. Understanding how management uses the information and how the pricing service operates assists the auditor in determining the nature and extent of audit procedures needed.

117. The following matters may be relevant where management uses a third-party pricing source:

- *The type of third-party pricing source* – Some third-party pricing sources make more information available about their process. For example, a pricing service often provides information about their methodology, assumptions and data in valuing financial instruments at the asset class level. By contrast, brokers often provide no, or only limited, information about the inputs and assumptions used in developing the quote.

- *The nature of inputs used and the complexity of the valuation technique* – The reliability of prices from third-party pricing sources varies depending on the observability of inputs (and accordingly, the level of inputs in the fair value hierarchy), and the complexity of the methodology for valuing a specific security or asset class. For example, the reliability of a price for an equity investment actively traded in a liquid market is higher than that of a corporate bond traded in a liquid market that has not traded on the measurement date, which, in turn, is more reliable than that of an asset-backed security that is valued using a discounted cash flow model.

- *The reputation and experience of the third-party pricing source* – For example, a third-party pricing source may be experienced in a certain type of financial instrument, and be recognized as such, but may not be similarly experienced in other types of financial instruments. The auditor's past experience with the third-party pricing source may also be relevant in this regard.

- *The objectivity of the third-party pricing source* – For example, if a price obtained by management comes from a counterparty such as the broker who sold the financial instrument to the entity, or an entity with a close relationship with the entity being audited, the price may not be reliable.

- *The entity's controls over the use of third-party pricing sources* – The degree to which management has controls in place to assess the reliability of information from third-party pricing sources affects the reliability of the fair value measurement. For example, management may have controls in place to:
    - Review and approve the use of the third-party pricing source, including consideration of the reputation, experience and objectivity of the third-party pricing source.
    - Determine the completeness, relevance and accuracy of the prices and pricing-related data.

- *The third-party pricing source's controls* – The controls and processes over valuations for the asset classes of interest to the auditor. For example, a third-party pricing source may have strong controls around how prices are developed, including the use of a formalized process for customers, both buy and sell side, to challenge the prices received from the pricing service, when supported by appropriate evidence, which may enable the third-party pricing source to constantly correct prices to more fully reflect the information available to market participants.

118. Possible approaches to gathering evidence regarding information from third-party pricing sources may include the following:

- For level 1 inputs, comparing the information from third-party pricing sources with observable market prices.
- Reviewing disclosures provided by third-party pricing sources about their controls and processes, valuation techniques, inputs and assumptions.
- Testing the controls management has in place to assess the reliability of information from third-party pricing sources.
- Performing procedures at the third-party pricing source to understand and test the controls and processes, valuation techniques, inputs and assumptions used for asset classes or specific financial instruments of interest.
- Evaluating whether the prices obtained from third-party pricing sources are reasonable in relation to prices from other third-party pricing sources, the entity's estimate or the auditor's own estimate.
- Evaluating the reasonableness of valuation techniques, assumptions and inputs.
- Developing a point estimate or a range for some financial instruments priced by the third-party pricing source and evaluating whether the results are within a reasonable range of each other.
- Obtaining a service auditor's report that covers the controls over validation of the prices.[31]

119. Obtaining prices from multiple third-party pricing sources may also provide useful information about measurement uncertainty. A wide range of prices may indicate higher measurement uncertainty and may suggest that the financial instrument is sensitive to small changes in data and assumptions. A narrow range may indicate lower measurement uncertainty and may suggest less sensitivity to changes in data and assumptions. Although obtaining prices from multiple sources may be useful, when considering financial instruments that have inputs categorized at levels 2 or 3 of the fair value hierarchy, in particular, obtaining prices from multiple sources is unlikely to provide sufficient appropriate audit evidence on its own. This is because:

(a) What appear to be multiple sources of pricing information may be utilizing the same underlying pricing source; and

(b) Understanding the inputs used by the third-party pricing source in determining the price may be necessary in order to categorize the financial instrument in the fair value hierarchy.

120. In some situations, the auditor may be unable to gain an understanding of the process used to generate the price, including any controls over the process of how reliably the price is determined, or may not have access to the model, including the assumptions and other inputs used. In such cases, the auditor may decide to undertake to develop a point estimate or a range to evaluate management's point estimate in responding to the assessed risk.

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[31] Some pricing services may provide reports for users of its data to explain their controls over pricing data, that is, a report prepared in accordance with Hong Kong Standard on Assurance Engagements (HKSAE) 3402, *Assurance Reports on Controls at a Service Organization*. Management may request, and the auditor may consider obtaining, such a report to develop an understanding of how the pricing data is prepared and evaluate whether the controls at the pricing service can be relied upon.

Audit Considerations When Management Estimates Fair Values Using a Model

121. Paragraph 13(b) of HKSA 540 requires the auditor, if testing management's process of making the accounting estimate, to evaluate whether the method of measurement used is appropriate in the circumstances and the assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.

122. Whether management has used a third-party pricing source, or is undertaking its own valuation, models are often used to value financial instruments, particularly when using inputs at levels 2 and 3 of the fair value hierarchy. In determining the nature, timing and extent of audit procedures on models, the auditor may consider the methodology, assumptions and data used in the model. When considering more complex financial instruments such as those using level 3 inputs, testing all three may be a useful source of audit evidence. However, when the model is both simple and generally accepted, such as some bond price calculations, audit evidence obtained from focusing on the assumptions and data used in the model may be a more useful source of evidence.

123. Testing a model can be accomplished by two main approaches:

    (a) The auditor can test management's model, by considering the appropriateness of the model used by management, the reasonableness of the assumptions and data used, and the mathematical accuracy; or

    (b) The auditor can develop their own estimate, and then compare the auditor's valuation with that of the entity.

124. Where valuation of financial instruments is based on unobservable inputs (that is, level 3 inputs), matters that the auditor may consider include, for example, how management supports the following:

    - The identification and characteristics of marketplace participants relevant to the financial instrument.
    - How unobservable inputs are determined on initial recognition.
    - Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
    - Whether it has incorporated the best input information available in the circumstances.
    - Where applicable, how its assumptions take account of comparable transactions.
    - Sensitivity analysis of models when unobservable inputs are used and whether adjustments have been made to address measurement uncertainty.

125. In addition, the auditor's industry knowledge, knowledge of market trends, understanding of other entities' valuations (having regard to confidentiality) and other relevant price indicators informs the auditor's testing of the valuations and the consideration of whether the valuations appear reasonable overall. If the valuations appear to be consistently overly aggressive or conservative, this may be an indicator of possible management bias.

126. Where there is a lack of observable external evidence, it is particularly important that those charged with governance have been appropriately engaged to understand the subjectivity of management's valuations and the evidence that has been obtained to support these valuations. In such cases, it may be necessary for the auditor to evaluate whether there has been a thorough review and consideration of the issues, including any documentation, at all appropriate management levels within the entity, including with those charged with governance.

127. When markets become inactive or dislocated, or inputs are unobservable, management's valuations may be more judgmental and less verifiable and, as result, may be less reliable. In such circumstances, the auditor may test the model by a combination of testing controls operated by the entity, evaluating the design and operation of the model, testing the assumptions and data used in the model, and comparing its output to a point estimate or range developed by the auditor or to other third-party valuation techniques.[32]

128. It is likely that in testing the inputs used in an entity's valuation methodology,[33] for example, where such inputs are categorized in the fair value hierarchy, the auditor will also be obtaining evidence to support the disclosures required by the applicable financial reporting framework. For example, the auditor's substantive procedures to evaluate whether the inputs used in an entity's valuation technique (that is, level 1, level 2 and level 3 inputs) are appropriate, and tests of an entity's sensitivity analysis, will be relevant to the auditor's evaluation of whether the disclosures achieve fair presentation.

Evaluating Whether the Assumptions Used by Management Are Reasonable

129. An assumption used in a model may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the financial instrument.[34] Management may have considered alternative assumptions or outcomes by performing a sensitivity analysis. The extent of subjectivity associated with assumptions influences the degree of measurement uncertainty and may lead the auditor to conclude there is a significant risk, for example in the case of level 3 inputs.

130. Audit procedures to test the assumptions used by management, including those used as inputs to models, may include evaluating:

- Whether, and if so, how, management has incorporated market inputs into the development of assumptions, as it is generally preferable to seek to maximize the use of relevant observable inputs and minimize unobservable inputs;

- Whether the assumptions are consistent with observable market conditions, and the characteristics of the financial asset or financial liability;

- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different marketplace assumptions exist; and

- Whether sensitivity analyses indicate that valuations would change significantly with only small or moderate changes in assumptions.

See paragraphs A77 to A83 of HKSA 540 for further considerations relative to evaluating the assumptions used by management.

131. The auditor's consideration of judgments about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

[32] HKSA 540, paragraph 13(d) describes requirements when the auditor develops a range to evaluate management's point estimate. Valuation techniques developed by third parties and used by the auditor may, in some circumstances be considered the work of an auditor's expert and subject to the requirements in HKSA 620.

[33] See, for example, paragraph 15 of HKSA 540 for requirements relative to the auditor's evaluation of management's assumption regarding significant risks.

[34] See HKSA 540, paragraph A107

132. In some cases, the discount rate in a present value calculation may be adjusted to account for the uncertainties in the valuation, rather than adjusting each assumption. In such cases, an auditor's procedures may focus on the discount rate, by looking at an observable trade on a similar security to compare the discount rates used or developing an independent model to calculate the discount rate and compare with that used by management.

Audit Considerations When a Management's Expert Is Used by the Entity

133. As discussed in Section I, management may engage a valuation expert to value some or all of their securities. Such experts may be brokers, investment bankers, pricing services that also provide expert valuation services, or other specialized valuation firms.

134. Paragraph 8 of HKSA 500 contains requirements for the auditor when evaluating evidence from an expert engaged by management. The extent of the auditor's procedures in relation to a management's expert and that expert's work depend on the significance of the expert's work for the auditor's purposes. Evaluating the appropriateness of management's expert's work assists the auditor in assessing whether the prices or valuations supplied by a management's expert provide sufficient appropriate audit evidence to support the valuations. Examples of procedures the auditor may perform include:

- Evaluating the competence, capabilities and objectivity of management's expert for example: their relationship with the entity; their reputation and standing in the market; their experience with the particular types of instruments; and their understanding of the relevant financial reporting framework applicable to the valuations;

- Obtaining an understanding of the work of the management's expert, for example by assessing the appropriateness of the valuation technique(s) used and the key market variables and assumptions used in the valuation technique(s);

- Evaluating the appropriateness of that expert's work as audit evidence. At this point, the focus is on the appropriateness of the expert's work at the level of the individual financial instrument. For a sample of the relevant instruments, it may be appropriate to develop an estimate independently (see paragraphs 136 to 137 on developing a point estimate or range), using different data and assumptions, then compare that estimate to that of the management's expert; and

- Other procedures may include:

    - Modeling different assumptions to derive assumptions in another model, then considering the reasonableness of those derived assumptions.

    - Comparing management's point estimates with the auditor's point estimates to determine if management's estimates are consistently higher or lower.

135. Assumptions may be made or identified by a management's expert to assist management in valuing its financial instruments. Such assumptions, when used by management, become management's assumptions that the auditor needs to consider in the same manner as management's other assumptions.

Developing a Point Estimate or Range

136. An auditor may develop a valuation technique and adjust the inputs and assumptions used in the valuation technique to develop a range for use in evaluating the reasonableness of management's valuation. Paragraphs 106 to 135 of this HKAPG may assist the auditor in developing a point estimate or range. In accordance with HKSA 540,[35] if the auditor uses

[35] HKSA 540, paragraph 13(c)

assumptions, or methodologies that differ from management's, the auditor shall obtain an understanding of management's assumptions or methodologies sufficient to establish that the auditor's range takes into account relevant variables and to evaluate any significant differences from management's valuation. The auditor may find it useful to use the work of an auditor's expert to evaluate the reasonableness of management's valuation.

137. In some cases, the auditor may conclude that sufficient evidence cannot be obtained from the auditor's attempts to obtain an understanding of management's assumptions or methodology, for example when a third-party pricing source uses internally developed models and software and does not allow access to relevant information. In such cases, the auditor may not be able to obtain sufficient appropriate audit evidence about the valuation if the auditor is unable to perform other procedures to respond to the risks of material misstatement, such as developing a point estimate or a range to evaluate management's point estimate.[36] HKSA 705[37] describes the implications of the auditor's inability to obtain sufficient appropriate audit evidence.

Presentation and Disclosure of Financial Instruments

138. Management's responsibilities include the preparation of the financial statements in accordance with the applicable financial reporting framework.[38] Financial reporting frameworks often require disclosures in the financial statements to enable users of the financial statements to make meaningful assessments of the effects of the entity's financial instrument activities, including the risks and uncertainties associated with these financial instruments. The importance of disclosures regarding the basis of measurement increases as the measurement uncertainty of the financial instruments increases and is also affected by the level of the fair value hierarchy.

139. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding the presentation and disclosure of the various elements of financial statements and related disclosures. Assertions about presentation and disclosure encompass:

(a) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

(b) Completeness—all disclosures that should have been included in the financial statements have been included.

(c) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.

(d) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

The auditor's procedures around auditing disclosures are designed in consideration of these assertions.

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36 HKSA 540, paragraph 13(d)

37 HKSA 705, *Modifications to the Opinion in the Independent Auditor's Report*

38 See paragraphs 4 and A2 of HKSA 200.

Procedures Relating to the Presentation and Disclosure of Financial Instruments

140. In relation to the presentation and disclosures of financial instruments, areas of particular importance include:

- Financial reporting frameworks generally require additional disclosures regarding estimates, and related risks and uncertainties, to supplement and explain assets, liabilities, income, and expenses. The auditor's focus may need to be on the disclosures relating to risks and sensitivity analysis. Information obtained during the auditor's risk assessment procedures and testing of control activities may provide evidence in order for the auditor to conclude about whether the disclosures in the financial statements are in accordance with the requirements of the applicable financial reporting framework, for example about:

    - The entity's objectives and strategies for using financial instruments, including the entity's stated accounting policies;

    - The entity's control framework for managing its risks associated with financial instruments; and

    - The risks and uncertainties associated with the financial instruments.

- Information may come from systems outside traditional financial reporting systems, such as risk systems. Examples of procedures that the auditor may choose to perform in responding to assessed risks relative to disclosures include testing:

    - The process used to derive the disclosed information; and

    - The operating effectiveness of the controls over the data used in the preparation of disclosures.

- In relation to financial instruments having significant risk,[39] even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved and, accordingly, the financial statements may not achieve fair presentation. HKSA 705 provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosures in the financial statements are inadequate or misleading.

- Auditors may also consider whether the disclosures are complete and understandable, for example, all relevant information may be included in the financial statements (or accompanying reports) but it may be insufficiently drawn together to enable users of the financial statements to obtain an understanding of the position or there may not be enough qualitative disclosure to give context to the amounts recorded in the financial statements. For example, even when an entity has included sensitivity analysis disclosures, the disclosure may not fully describe the risks and uncertainties that may arise because of changes in valuation, possible effects on debt covenants, collateral requirements, and the entity's liquidity. HKSA 260[40] contains requirements and guidance about communicating with those charged with governance, including the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

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39 HKSA 540, paragraph 20, requires the auditor to perform further procedures on disclosures relating to accounting estimates that give rise to significant risks to evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

40 HKSA 260, *Communication with Those Charged with Governance*

141. Consideration of the appropriateness of presentation, for example on short-term and long-term classification, in substantive testing of financial instruments is relevant to the auditor's evaluation of the presentation and disclosure.

Other Relevant Audit Considerations

Written Representations

142. HKSA 540 requires the auditor to obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.[41] HKSA 580[42] requires that if, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. Depending on the volume and degree of complexity of financial instrument activities, written representations to support other evidence obtained about financial instruments may also include:

- Management's objectives with respect to financial instruments, for example, whether they are used for hedging, asset/liability management or investment purposes;
- Representations about the appropriateness of presentation of the financial statements, for example the recording of financial instrument transactions as sales or financing transactions;
- Representations about the financial statement disclosures concerning financial instruments, for example that:
    - The records reflect all financial instrument transactions; and
    - All embedded derivative instruments have been identified;
- Whether all transactions have been conducted at arm's length and at market value;
- The terms of transactions;
- The appropriateness of the valuations of financial instruments;
- Whether there are any side agreements associated with any financial instruments;
- Whether the entity has entered into any written options;
- Management's intent and ability to carry out certain actions;[43] and
- Whether subsequent events require adjustment to the valuations and disclosures included in the financial statements.

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41 HKSA 540, paragraph 22. Paragraph 4 of HKSA 580, *Written Representations*, states that written representations from management do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. If the auditor is otherwise unable to obtain sufficient appropriate audit evidence, this may constitute a limitation on the scope of the audit that may have implications for the auditor's report (see HKSA 705, *Modification to the Opinion in the Independent Auditor's Report*).

42 HKSA 580 paragraph 13

43 Paragraph A80 of HKSA 540 provides examples of procedures that may be appropriate in the circumstances.

Communication with Those Charged with Governance and Others

143. Because of the uncertainties associated with the valuation of financial instruments, the potential effects on the financial statements of any significant risks are likely to be of governance interest. The auditor may communicate the nature and consequences of significant assumptions used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being measured at fair value to the financial statements as a whole. In addition, the need for appropriate controls over commitments to enter into financial instrument contracts and over the subsequent measurement processes are matters that may give rise to the need for communication with those charged with governance.

144. HKSA 260 deals with the auditor's responsibility to communicate with those charged with governance in an audit of financial statements. With respect to financial instruments, matters to be communicated to those charged with governance may include:

- A lack of management understanding of the nature or extent of the financial instrument activities or the risks associated with such activities;
- Significant deficiencies in the design or operation of the systems of internal control or risk management relating to the entity's financial instrument activities that the auditor has identified during the audit;[44]
- Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to valuations performed by management or a management's expert, for example, where management is unable to obtain an understanding of the valuation methodology, assumptions and data used by the management's experts, and such information is not made available to the auditor by management' s expert;
- Significant differences in judgments between the auditor and management or a management's expert regarding valuations;
- The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the measurement uncertainty associated with financial instruments;
- The auditor's views about the appropriateness of the selection of accounting policies and presentation of financial instrument transactions in the financial statements;
- The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for financial instruments; or
- A lack of comprehensive and clearly stated policies for the purchase, sale and holding of financial instruments, including operational controls, procedures for designating financial instruments as hedges, and monitoring exposures.

The appropriate timing for communications will vary with the circumstances of the engagement; however, it may be appropriate to communicate significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulty, or if it is likely to lead to a modified opinion.

[44] HKSA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, establishes requirements and provides guidance on communicating deficiencies in internal control to management, and communicating significant deficiencies in internal control to those charged with governance. It explains that deficiencies in internal control may be identified during the auditor's risk assessment procedures in accordance with HKSA 315 or at any other stage of the audit.

Communications with Regulators and Others

145. In some cases, auditors may be required,[45] or may consider it appropriate, to communicate directly with regulators or prudential supervisors, in addition to those charged with governance, regarding matters relating to financial instruments. Such communication may be useful throughout the audit. For example, in some jurisdictions, banking regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, and compliance with regulations. This coordination may be helpful to the auditor in identifying risks of material misstatement.

Conformity and Compliance with International Auditing Practice Notes

146. This HKAPG is, in all material respects, in accordance with International Auditing Practice Note (IAPN) 1000, “Special Considerations in Auditing Financial Instruments”.

[45] For example, HKSA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, requires auditors to determine whether there is a responsibility to report identified or suspected non-compliance with laws and regulations to parties outside the entity. In addition, requirements concerning the auditor’s communication to banking supervisors and others may be established in many countries either by law, by supervisory requirement or by formal agreement or protocol.

Appendix

Examples of Controls Relating to Financial Instruments

1. The following provides background information and examples of controls that may exist in an entity that deals in a high volume of financial instrument transactions, whether for trading or investing purposes. The examples are not meant to be exhaustive and entities may establish different control environments and processes depending on their size, the industry in which they operate, and the extent of their financial instrument transactions. Further information on the use of trade confirmations and clearing houses is contained in paragraphs 25–26.

2. As in any control system, it is sometimes necessary to duplicate controls at different control levels (for example, preventative, detective and monitoring) to avoid the risk of material misstatement.

The Entity's Control Environment

Commitment to Competent Use of Financial Instruments

3. The degree of complexity of some financial instrument activities may mean that only a few individuals within the entity fully understand those activities or have the expertise necessary to value the instruments on an ongoing basis. Use of financial instruments without relevant expertise within the entity increases the risk of material misstatement.

Participation by Those Charged with Governance

4. Those charged with governance oversee and concur with management's establishment of the entity's overall risk appetite and provide oversight over the entity's financial instrument activities. An entity's policies for the purchase, sale and holding of financial instruments are aligned with its attitude toward risk and the expertise of those involved in financial instrument activities. In addition, an entity may establish governance structures and control processes aimed at:

   (a) Communicating investment decisions and assessments of all material measurement uncertainty to those charged with governance; and

   (b) Evaluating the entity's overall risk appetite when engaging in financial instrument transactions.

Organizational Structure

5. Financial instrument activities may be run on either a centralized or a decentralized basis. Such activities and related decision making depend heavily on the flow of accurate, reliable, and timely management information. The difficulty of collecting and aggregating such information increases with the number of locations and businesses in which an entity is involved. The risks of material misstatement associated with financial instrument activities may increase with greater decentralization of control activities. This may especially be true where an entity is based in different locations, some perhaps in other countries.

Assignment of Authority and Responsibility

Investment and Valuation Policies

6. Providing direction, through clearly stated policies approved by those charged with governance for the purchase, sale, and holding of financial instruments enables management to establish an effective approach to taking and managing business risks. These policies are most clear when they state the entity's objectives with regard to its risk management activities, and the investment and hedging alternatives available to meet these objectives, and reflect the:

   (a) Level of management's expertise;

   (b) Sophistication of the entity's internal control and monitoring systems;

   (c) Entity's asset/liability structure;

   (d) Entity's capacity to maintain liquidity and absorb losses of capital;

   (e) Types of financial instruments that management believes will meet its objectives; and

   (f) Uses of financial instruments that management believes will meet its objectives, for example, whether derivatives may be used for speculative purposes or only for hedging purposes.

7. Management may design policies aligned with its valuation capabilities and may establish controls to ensure that these policies are adhered to by those employees responsible for the entity's valuation. These may include:

   (a) Processes for the design and validation of methodologies used to produce valuations, including how measurement uncertainty is addressed; and

   (b) Policies regarding maximizing the use of observable inputs and the types of information to be gathered to support valuations of financial instruments.

8. In smaller entities, dealing in financial instruments may be rare and management's knowledge and experience limited. Nevertheless, establishing policies over financial instruments helps an entity to determine its risk appetite and consider whether investing in particular financial instruments achieves a stated objective.

Human Resource Policies and Practices

9. Entities may establish policies requiring key employees, both front office and back office, to take mandatory time off from their duties. This type of control is used as a means of preventing and detecting fraud, in particular if those engaged in trading activities are creating false trades or inaccurately recording transactions.

Use of Service Organizations

10. Entities may also use service organizations (for example asset managers) to initiate the purchase or sale of financial instruments, to maintain records of transactions for the entity or to value financial instruments. Some entities may be dependent on these service organizations to provide the basis of reporting for the financial instruments held. However, if management does not have an understanding about the controls in place at a service organization, the auditor may not be able to obtain sufficient appropriate audit evidence to rely on controls at that service organization. See HKSA 402, which establishes requirements for the auditor to obtain sufficient appropriate audit evidence when an entity uses the services of one or more service organizations.

11. The use of service organizations may strengthen or weaken the control environment for financial instruments. For example, a service organization's personnel may have more experience with financial instruments than the entity's management or may have more robust internal control over financial reporting. The use of the service organization also may allow for greater segregation of duties. On the other hand, the service organization may have a poor control environment.

The Entity's Risk Assessment Process

12. An entity's risk assessment process exists to establish how management identifies business risks that derive from its use of financial instruments, including how management estimates the significance of the risks, assesses the likelihood of their occurrence and decides upon actions to manage them.

13. The entity's risk assessment process forms the basis for how management determines the risks to be managed. Risk assessment processes exist with the objective of ensuring that management:

    (a) Understands the risks inherent in a financial instrument before they enter into it, including the objective of entering into the transaction and its structure (for example, the economics and business purpose of the entity's financial instrument activities);

    (b) Performs adequate due diligence commensurate with the risks associated with particular financial instruments;

    (c) Monitors their outstanding positions to understand how market conditions are affecting their exposures;

    (d) Has procedures in place to reduce or change risk exposure if necessary and for managing reputational risk; and

    (e) Subjects these processes to rigorous supervision and review.

14. The structure implemented to monitor and manage exposure to risks should:

    (a) Be appropriate and consistent with the entity's attitude toward risk as determined by those charged with governance;

    (b) Specify the approval levels for the authorization of different types of financial instruments and transactions that may be entered into and for what purposes. The permitted instruments and approval levels should reflect the expertise of those involved in financial instrument activities, demonstrating management's commitment to competence;

    (c) Set appropriate limits for the maximum allowable exposure to each type of risk (including approved counterparties). Levels of allowable exposure may vary depending on the type of risk, or counterparty;

    (d) Provide for the objective and timely monitoring of the financial risks and control activities;

    (e) Provide for the objective and timely reporting of exposures, risks and the results of financial instrument activities in managing risk; and

    (f) Evaluate management's track record for assessing the risks of particular financial instruments.

15. The types and levels of risks an entity faces are directly related to the types of financial instruments with which it deals, including the complexity of these instruments and the volume of financial instruments transacted.

Risk Management Function

16. Some entities, for example large financial institutions with a high volume of financial instrument transactions, may be required by law or regulation, or may choose, to establish a formal risk management function. This function is separated from those responsible for undertaking and managing financial instrument transactions. The function is responsible for reporting on and monitoring financial instrument activities, and may include a formal risk committee established by those charged with governance. Examples of key responsibilities in this area may include:

    (a) Implementing the risk management policy set by those charged with governance (including analyses of the risks to which an entity may be exposed);

    (b) Designing risk limit structures and ensuring these risk limits are implemented in practice;

    (c) Developing stress scenarios and subjecting open position portfolios to sensitivity analysis, including reviews of unusual movements in positions; and

    (d) Reviewing and analyzing new financial instrument products.

17. Financial instruments may have the associated risk that a loss might exceed the amount, if any, of the value of the financial instrument recognized on the balance sheet. For example, a sudden fall in the market price of a commodity may force an entity to realize losses to close a forward position in that commodity due to collateral, or margin, requirements. In some cases, the potential losses may be enough to cast significant doubt on the entity's ability to continue as a going concern. The entity may perform sensitivity analyses or value-at-risk analyses to assess the future hypothetical effects on financial instruments subject to market risks. However, value-at-risk analysis does not fully reflect the extent of the risks that may affect the entity; sensitivity and scenario analyses also may be subject to limitations.

18. The volume and sophistication of financial instrument activity and relevant regulatory requirements will influence the entity's consideration whether to establish a formal risk management function and how the function may be structured. In entities that have not established a separate risk management function, for example entities with relatively few financial instruments or financial instruments that are less complex, reporting on and monitoring financial instrument activities may be a component of the accounting or finance function's responsibility or management's overall responsibility, and may include a formal risk committee established by those charged with governance

The Entity's Information Systems

19. The key objective of an entity's information system is that it is capable of capturing and recording all the transactions accurately, settling them, valuing them, and producing information to enable the financial instruments to be risk managed and for controls to be monitored. Difficulties can arise in entities that engage in a high volume of financial instruments, in particular if there is a multiplicity of systems that are poorly integrated and have manual interfaces without adequate controls.

20. Certain financial instruments may require a large number of accounting entries. As the sophistication or level of the financial instrument activities increases, it is necessary for the sophistication of the information system to also increase. Specific issues which can arise with respect to financial instruments include:

    (a) Information systems, in particular for smaller entities, not having the capability or not being appropriately configured to process financial instrument transactions, especially when the entity does not have any prior experience in dealing with financial instruments. This may result in an increased number of manual transactions which may further increase the risk of error;

(b) The potential diversity of systems required to process more complex transactions, and the need for regular reconciliations between them, in particular when the systems are not interfaced or may be subject to manual intervention;

(c) The potential that more complex transactions, if they are only traded by a small number of individuals, may be valued or risk managed on spreadsheets rather than on main processing systems, and for the physical and logical password security around those spreadsheets to be more easily compromised;

(d) A lack of review of systems exception logs, external confirmations and broker quotes, where available, to validate the entries generated by the systems;

(e) Difficulties in controlling and evaluating the key inputs to systems for valuation of financial instruments, particularly where those systems are maintained by the group of traders known as the front office or a third-party service provider and/or the transactions in question are non-routine or thinly traded;

(f) Failure to evaluate the design and calibration of complex models used to process these transactions initially and on a periodic basis;

(g) The potential that management has not set up a library of models, with controls around access, change and maintenance of individual models, in order to maintain a strong audit trail of the accredited versions of models and in order to prevent unauthorized access or amendments to those models;

(h) The disproportionate investment that may be required in risk management and control systems, where an entity only undertakes a limited number of financial instrument transactions, and the potential for misunderstanding of the output by management if they are not used to these types of transactions;

(i) The potential requirement for third-party systems provision, for example from a service organization, to record, process, account for or risk manage appropriately financial instrument transactions, and the need to reconcile appropriately and challenge the output from those providers; and

(j) Additional security and control considerations relevant to the use of an electronic network when an entity uses electronic commerce for financial instrument transactions.

21. Information systems relevant to financial reporting serve as an important source of information for the quantitative disclosures in the financial statements. However, entities may also develop and maintain non-financial systems used for internal reporting and to generate information included in qualitative disclosures, for example regarding risks and uncertainties or sensitivity analyses.

The Entity's Control Activities

22. Control activities over financial instrument transactions are designed to prevent or detect problems that hinder an entity from achieving its objectives. These objectives may be either operational, financial reporting, or compliance in nature. Control activities over financial instruments are designed relative to the complexity and volume of transactions of financial instruments and will generally include an appropriate authorization process, adequate segregation of duties, and other policies and procedures designed to ensure that the entity's control objectives are met. Process flow charts may assist in identifying an entity's controls and lack of controls. This HKAPG focuses on control activities related to completeness, accuracy and existence, valuation, and presentation and disclosure.

Authorization

23. Authorization can affect the financial statement assertions both directly and indirectly. For example, even if a transaction is executed outside an entity's policies, it nonetheless may be recorded and accounted for accurately. However, unauthorized transactions could significantly increase risk to the entity, thereby significantly increasing the risk of material misstatement since they would be undertaken outside the system of internal control. To mitigate this risk, an entity will often establish a clear policy as to what transactions can be traded by whom and adherence to this policy will then be monitored by an entity's back office. Monitoring trading activities of individuals, for example by reviewing unusually high volumes or significant gains or losses incurred, will assist management in ensuring compliance with the entity's policies, including the authorization of new types of transactions, and evaluating whether fraud has occurred.

24. The function of an entity's deal initiation records is to identify clearly the nature and purpose of individual transactions and the rights and obligations arising under each financial instrument contract, including the enforceability of the contracts. In addition to the basic financial information, such as a notional amount, complete and accurate records at a minimum typically include:

    (a) The identity of the dealer;

    (b) The identity of the person recording the transaction (if not the dealer), when the transaction was initiated (including the date and time of the transaction), and how it was recorded in the entity's information systems; and

    (c) The nature and purpose of the transaction, including whether or not it is intended to hedge an underlying commercial exposure.

Segregation of Duties

25. Segregation of duties and the assignment of personnel is an important control activity, particularly when exposed to financial instruments. Financial instrument activities may be segregated into a number of functions, including:

    (a) Executing the transaction (dealing). In entities with a high volume of financial instrument transactions, this may be done by the front office;

    (b) Initiating cash payments and accepting cash receipts (settlements);

    (c) Sending out trade confirmations and reconciling the differences between the entity's records and replies from counterparties, if any;

    (d) Recording of all transactions correctly in the accounting records;

    (e) Monitoring risk limits. In entities with a high volume of financial instrument transactions, this may be performed by the risk management function; and

    (f) Monitoring positions and valuing financial instruments.

26. Many organizations choose to segregate the duties of those investing in financial instruments, those valuing financial instruments, those settling financial instruments and those accounting/recording financial instruments.

27. Where an entity is too small to achieve proper segregation of duties, the role of management and those charged with governance in monitoring financial instrument activities is of particular importance.

28. A feature of some entities' internal control is an independent price verification (IPV) function. This department is responsible for separately verifying the price of some financial instruments, and may use alternative data sources, methodologies and assumptions. The IPV provides an objective look at the pricing that has been developed in another part of the entity.

29. Ordinarily, the middle or back office is responsible for establishing policies on valuation and ensuring adherence to the policy. Entities with a greater use of financial instruments may perform daily valuations of their financial instrument portfolio and examine the contribution to profit or loss of individual financial instrument valuations as a test of the reasonableness of valuations.

Completeness, Accuracy, and Existence

30. Regular reconciliation of the entity's records to external banks' and custodians' records enables the entity to ensure transactions are properly recorded. Appropriate segregation of duties between those transacting the trades and those reconciling them is important, as is a rigorous process for reviewing reconciliations and clearing reconciling items.

31. Controls may also be established that require traders to identify whether a complex financial instrument may have unique features, for example embedded derivatives. In such circumstances, there may be a separate function that evaluates complex financial instrument transactions at their initiation (which may be known as a product control group), working in connection with an accounting policy group to ensure the transaction is accurately recorded. While smaller entities may not have product control groups, an entity may have a process in place relating to the review of complex financial instrument contracts at the point of origination in order to ensure they are accounted for appropriately in accordance with the applicable financial reporting framework.

Monitoring of Controls

32. The entity's ongoing monitoring activities are designed to detect and correct any deficiencies in the effectiveness of controls over transactions for financial instruments and their valuation. It is important that there is adequate supervision and review of financial instrument activity within the entity. This includes:

    (a) All controls being subject to review, for example, the monitoring of operational statistics such as the number of reconciling items or the difference between internal pricing and external pricing sources;

    (b) The need for robust information technology (IT) controls and monitoring and validating their application; and

    (c) The need to ensure that information resulting from different processes and systems is adequately reconciled. For example, there is little benefit in a valuation process if the output from it is not reconciled properly into the general ledger.

33. In larger entities, sophisticated computer information systems generally keep track of financial instrument activities, and are designed to ensure that settlements occur when due. More complex computer systems may generate automatic postings to clearing accounts to monitor cash movements, and controls over processing are put in place with the objective of ensuring that financial instrument activities are correctly reflected in the entity's records. Computer systems may be designed to produce exception reports to alert management to situations where financial instruments have not been used within authorized limits or where transactions undertaken were not within the limits established for the chosen counterparties. However, even a sophisticated computer system may not ensure the completeness of the recording of financial instrument transactions. Accordingly, management frequently put additional procedures in place to increase the likelihood that all transactions will be recorded.