Update No. 90

(Issued 30 July 2010)

Editorial changes to the clarified auditing standards

1. In April 2010, the International Federation of Accountants published the 2010 edition of the *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* (2010 Handbook) and made editorial and formatting changes in finalizing the 2010 Handbook. As part of the convergence with the International Standards on Quality Control and Auditing, the changes have been made to the Hong Kong Standards on Quality Control and Auditing. To assist users, a Consolidated Table of Changes outlines these editorial and formatting changes which is posted at: http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/handbook/table-consolidate-change.pdf

2. PN 1001"*IT Environments-Stand-alone personal computers*", PN 1002 "*IT Environments – On-line Computer Systems*", PN 1003 "*IT Environments – Database Systems*" and PN 1009 "*Computer-Assisted Audit Techniques*" are withdrawn as the corresponding International Auditing Practice Statements 1001, 1002, 1003 and 1009 had been withdrawn.

Document Reference and Title	***Instructions***	***Explanations***
VOLUME III		
Contents of Volume III	Discard the existing pages i, iii - vi and replace with the new pages i, iii - vi.	Revised contents pages
HONG KONG CLARIFIED PRONOUNCEMENTS ON AUDITING		
Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Clarified)	Replace cover page, pages 4, 5, 8, 11, 16, 21 and 22 with revised cover page, pages 4, 5, 8, 11, 16, 21 and 22.	Note 1
HKSQC 1 (Clarified) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*	Replace cover page, pages 7, 9, 13, 18, 24, 25 and 30 with revised cover page, pages 7, 9, 13, 18, 24, 25 and 30.	- ditto -

HKSA 200 (Clarified) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*	Replace cover page, pages 5, 7, 11, 14, 15, 16, 18, 19, 21 and 26 with revised cover page, pages 5, 7, 11, 14, 15, 16, 18, 19, 21 and 26.	- ditto -
HKSA 210 (Clarified) *Agreeing The Terms of Audit Engagements*	Replace cover page and page 9 with revised cover page and page 9.	- ditto -
HKSA 220 (Clarified) *Quality Control for an Audit of Financial Statements*	Replace cover page, pages 4, 5, 9, 12, 14, 15 and 16 with revised cover page, pages 4, 5, 9, 12, 14, 15 and 16.	- ditto -
HKSA 230 (Clarified) *Audit Documentation*	Replace cover page, pages 11 and 13 with revised cover page, pages 11 and 13.	- ditto -
HKSA 240 (Clarified) *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	Replace cover page, pages 5, 7 - 9, 11 - 12, 15, 17 – 18, 20, 24 - 26 and 29 with revised cover page, pages 5, 7 - 9, 11 - 12, 15, 17 – 18, 20, 24 - 26 and 29.	- ditto -
HKSA 250 (Clarified) *Consideration of Laws and Regulations in an Audit of Financial Statements*	Replace cover page, pages 4, 6, 8 and 13 with revised cover page, pages 4, 6, 8 and 13.	- ditto -
HKSA 260 (Clarified) *Communication with Those Charged with Governance*	Replace cover page, pages 8, 9, 17, 19 and 20 with revised cover page, pages 8, 9, 17, 19 and 20.	- ditto -
HKSA 265 (Clarified) *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*	Replace cover page, pages 9 and 10 with revised cover page, pages 9 and 10.	- ditto -
HKSA 300 (Clarified) *Planning an Audit of Financial Statements*	Replace cover page, pages 6, 8 and 12 with revised cover page, pages 6, 8 and 12.	- ditto -
HKSA 315 (Clarified) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	Replace cover page, pages 8, 10 - 11, 14 - 15, 17 - 18, 20, 27 - 28, 31 - 34, 38, 41 and 43 with revised cover page, pages 8, 10 - 11, 14 - 15, 17 - 18, 20, 27 - 28, 31 - 34, 38, 41 and 43.	- ditto -
HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit*	Replace cover page and page 6 with revised cover page and page 6.	- ditto -

HKSA 330 (Clarified) *The Auditor's Responses to Assessed Risks*	Replace cover page, pages 4 - 6, 8 - 10, 14, 16 - 17 and 20 with revised cover page, pages 4 - 6, 8 - 10, 14, 16 - 17 and 20.	- ditto -
HKSA 402 (Clarified) *Audit Considerations Relating to an Entity Using a Service Organization*	Replace cover page, pages 9 - 10, 12 - 13 and 19 with revised pages 9 - 10, 12 - 13 and 19.	- ditto -
HKSA 450 (Clarified) *Evaluation of Misstatements Identified during the Audit*	Replace cover page, pages 3, 6 and 11 with revised cover page, pages 3, 6 and 11.	- ditto -
HKSA 500 (Clarified) *Audit Evidence*	Replace cover page, pages 5, 12 and 14 - 15 with revised cover page, pages 5, 12 and 14 - 15.	- ditto -
HKSA 501 (Clarified) *Audit Evidence — Specific Considerations for Selected Items*	Replace cover page and pages 7 - 11 with revised cover page and pages 7 - 11.	- ditto -
HKSA 510 (Clarified) *Initial Audit Engagements—Opening Balances*	Replace cover page and pages 6 - 13 with revised cover page and pages 6 - 13.	- ditto -
HKSA 530 (Clarified) *Audit Sampling*	Replace cover page, pages 5 and 7 with revised cover page, pages 5 and 7.	- ditto -
HKSA 540 (Clarified) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*	Replace cover page, pages 9 - 11, 19, 22, 26, 28 - 29 and 37 with revised cover page, pages 9 - 11, 19, 22, 26, 28 - 29 and 37.	- ditto -
HKSA 550 (Clarified) *Related Parties*	Replace cover page, pages 6, 9, 18 and 23 with revised cover page, pages 6, 9, 18 and 23.	- ditto -
HKSA 560 (Clarified) *Subsequent Events*	Replace cover page and pages 5 - 10 with revised cover page and pages 5 - 10.	- ditto -
HKSA 570 (Clarified) *Going Concern*	Replace cover page, pages 5 - 6, 8, 12 and 14 with revised cover page, pages 5 - 6, 8, 12 and 14.	- ditto -
HKSA 580 (Clarified) *Written Representations*	Replace cover page, pages 5, 7, 10 and 14 - 15 with revised cover page, pages 5, 7, 10 and 14 - 15.	- ditto -
HKSA 600 (Clarified) *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*	Replace cover page, pages 3, 8, 15 - 16, 21, 34 - 35, 37 and 41 with revised cover page, pages 3, 8, 15 - 16, 21, 34 - 35, 37 and 41.	- ditto -

HKSA 610 (Clarified) *Using the Work of Internal Auditors*	Replace cover page and page 6 with revised cover page and page 6.	- ditto -
HKSA 620 (Clarified) *Using the Work of an Auditor's Expert*	Replace cover page and page 18 with revised cover page and page 18.	- ditto -
HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements*	Replace cover page, pages 5 - 6, 14, 19 - 20 and 22 - 29 with revised cover page, pages 5 - 6, 14, 19 - 20 and 22 - 29.	- ditto -
HKSA 705 (Clarified) *Modifications to the Opinion in the Independent Auditor's Report*	Replace cover page, pages 9 and 15 - 27 with revised cover page, pages 9 and 15 - 27.	- ditto -
HKSA 706 (Clarified) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	Replace cover page, pages 4 and 11 - 13 with revised cover page, pages 4 and 11 - 13.	- ditto -
HKSA 710 (Clarified) *Comparative Information—Corresponding Figures and Comparative Financial Statements*	Replace cover page and pages 10 - 17 with revised cover page and pages 10 - 17.	- ditto -
HKSA 720 (Clarified) *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*	Replace cover page and pages 4 - 5 with revised cover page and pages 4 - 5.	- ditto -
HKSA 800 (Clarified) *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*	Replace cover page, pages 8 and 11 - 16 with revised cover page and pages 8 and 11 - 16.	- ditto -
HKSA 805 (Clarified) *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*	Replace cover page, pages 5, 8 - 9 and 14 - 19 with revised cover page and pages 5, 8 - 9 and 14 - 19.	- ditto -
HKSA 810 (Clarified) *Engagements to Report on Summary Financial Statements*	Replace cover page, pages 11, 14, 17, 19, 21 - 23, 25 and 27 - 28 with revised cover page, pages 11, 14, 17, 19, 21 - 23, 25 and 27 - 28.	- ditto -

PRACTICE NOTES

PN 1001 *IT Environments – Stand-Alone Personal Computers*	Discard existing PN 1001.	Note 2
PN 1002 *IT Environments – On-Line Computer Systems*	Discard existing PN 1002.	- ditto -

PN 1003 *IT Environments – Database Systems*	Discard existing PN 1003.	- ditto -
PN 1009 *Computer-Assisted Audit Techniques*	Discard existing PN 1009.	- ditto -

Hong Kong Institute of
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MEMBERS' HANDBOOK
CONTENTS OF VOLUME III

(Updated to July 2010)

Effective as of 15 December 2009

Glossary of Terms Relating to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services

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Annual report - A document issued by an entity, ordinarily on an annual basis, which includes its financial statements together with the auditor's report thereon.

**Anomaly* - A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

**Applicable financial reporting framework* - The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(a) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(b) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.

Application controls in information technology - Manual or automated procedures that typically operate at a business process level. Application controls can be preventative 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.

**Applied criteria (in the context of HKSA 810* [3]*)* - The criteria applied by management in the preparation of the summary financial statements.

**Appropriateness (of audit evidence)* - The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

**Arm's length transaction* - A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

**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.

Assess - Analyze identified risks of material misstatement to conclude on their significance. "Assess," by convention, is used only in relation to risk. (also see *Evaluate*)

Association - (see *Auditor association with financial information*)

*†*Assurance* - (see *Reasonable assurance*)

[3] HKSA 810, "Engagements to Report on Summary Financial Statements."

Assurance engagement - An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria (also see *Subject matter information*). Under the "Hong Kong Framework for Assurance Engagements" there are two types of assurance engagement a practitioner is permitted to perform: a reasonable assurance engagement and a limited assurance engagement.

> *Reasonable assurance engagement* - The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement [4] as the basis for a positive form of expression of the practitioner's conclusion.
>
> *Limited assurance engagement* - The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

Assurance engagement risk - The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

**Audit documentation* - The record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "workpapers" are also sometimes used).

**Audit evidence* - Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. (See *Sufficiency of audit evidence* and *Appropriateness of audit evidence*.)

**Audit file* - One or more folders or other storage media, in physical or electronic form, containing the records that comprise the audit documentation for a specific engagement.

*†*Audit firm* - (see *Firm*)

**Audit opinion* - (see *Modified opinion and Unmodified opinion*)

**Audit risk* - The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.

**Audit sampling (sampling)* - The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

**Audited financial statements (in the context of HKSA 810)* - Financial statements [5] audited by the auditor in accordance with HKSAs, and from which the summary financial statements are derived.

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4 Engagement circumstances include the terms of the engagement, including whether it is a reasonable assurance engagement or a limited assurance engagement, the characteristics of the subject matter, the criteria to be used, the needs of the intended users, relevant characteristics of the responsible party and its environment, and other matters, for example events, transactions, conditions and practices, that may have a significant effect on the engagement.

5 HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraph 13(f) defines the term "financial statements."

**Date of the financial statements* - The date of the end of the latest period covered by the financial statements.

**Date the financial statements are issued* - The date that the auditor's report and audited financial statements are made available to third parties.

**Deficiency in internal control* - This exists when:

(a) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or

(b) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing.

**Detection risk* - The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

**Element* - (see *Element of a financial statement*)

**Element of a financial statement (in the context of HKSA 805* [8]*)* - An element, account or item of a financial statement.

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

†*Engagement documentation* - The record of work performed, results obtained, and conclusions the practitioner reached (terms such as "working papers" or "workpapers" are sometimes used).

Engagement letter - Written terms of an engagement in the form of a letter.

*†*Engagement partner* [9] - 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.

*†*Engagement quality control review* - A process designed to provide an objective evaluation, on or before the date of the report, of the significant judgments the engagement team made and the conclusions it reached in formulating the report. The engagement quality control review process is for audits of financial statements of listed entities and those other engagements, if any, for which the firm has determined an engagement quality control review is required.

*†*Engagement quality control reviewer* - A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the report.

*†*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.[10]

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8 HKSA 805, "Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement."

9 "Engagement partner," "partner," and "firm" should be read as referring to their public sector equivalents where relevant.

10 HKSA 620, "Using the Work of an Auditor's Expert," paragraph 6(a) defines the term "auditor's expert."

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (a) or (b) above.[11]

**Governance* - Describes the role of person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.

**Group* - All the components whose financial information is included in the group financial statements. A group always has more than one component.

**Group audit* - The audit of group financial statements.

**Group audit opinion* - The audit opinion on the group financial statements.

**Group engagement partner* - The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team.

**Group engagement team* - Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

**Group financial statements* - Financial statements that include the financial information of more than one component. The term "group financial statements" also refers to combined financial statements aggregating the financial information prepared by components that have no parent but are under common control.

**Group management* - Management responsible for the preparation of the group financial statements.

**Group-wide controls* - Controls designed, implemented and maintained by group management over group financial reporting.

**Historical financial information* - Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

**Hong Kong Financial Reporting Standards* - The Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants.

**Inconsistency* - Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

Independence [12] - Comprises:

(a) Independence of mind - the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism.

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[11] HKSA 200, paragraph 13(a).

[12] As defined in the HKICPA *Code of Ethics for Professional Accountants*.

(i) Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

In the case of a fair presentation framework, (a) above may be restated as "for the preparation and *fair* presentation of the financial statements in accordance with the financial reporting framework," or "for the preparation of financial statements *that give a true and fair view* in accordance with the financial reporting framework."

The "premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted" may also be referred to as the "premise."

Professional accountant [15] - An individual who is a member of the Hong Kong Institute of Certified Public Accountants.

Professional accountant in public practice [16] - A professional accountant, irrespective of functional classification (for example, audit, tax or consulting) in a firm that provides professional services. This term is also used to refer to a firm of professional accountants in public practice.

**Professional judgment* - The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

**Professional skepticism* - An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

**Professional standards* - Hong Kong Standards on Auditing (HKSAs) and relevant ethical requirements

[†]*Professional standards (in the context of HKSQC 1* [17]*)* - Hong Kong Engagement Standards, as defined in the *Preface to Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*, and relevant ethical requirements.

Projection - Prospective financial information prepared on the basis of:

(a) Hypothetical assumptions about future events and management actions which are not necessarily expected to take place, such as when some entities are in a startup phase or are considering a major change in the nature of operations; or

(b) A mixture of best-estimate and hypothetical assumptions.

Prospective financial information - Financial information based on assumptions about events that may occur in the future and possible actions by an entity. Prospective financial information can be in the form of a forecast, a projection or a combination of both. (see *Forecast* and *Projection*)

15 As defined in the HKICPA *Code of Ethics for Professional Accountants*.

16 As defined in the HKICPA *Code of Ethics for Professional Accountants*.

17 HKSQC 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements."

**Subservice organization* - A service organization used by another service organization to perform some of the services provided to user entities that are part of those user entities' information systems relevant to financial reporting.

**Substantive procedure* - An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(a) Tests of details (of classes of transactions, account balances, and disclosures); and

(b) Substantive analytical procedures.

**Sufficiency (of audit evidence)* - The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Suitable criteria - (see *Criteria*)

*†*Suitably qualified external person* - An individual outside the firm with the competence and capabilities to act as an engagement partner, for example a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organization that provides relevant quality control services.

**Summary financial statements (in the context of HKSA 810)* - Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time.[20] Different jurisdictions may use different terminology to describe such historical financial information.

Supplementary information - Information that is presented together with the financial statements that is not required by the applicable financial reporting framework used to prepare the financial statements, normally presented in either supplementary schedules or as additional notes.

Test - The application of procedures to some or all items in a population.

**Tests of controls* - An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

**Those charged with governance* - The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager.[21]

**Tolerable misstatement* - A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

**Tolerable rate of deviation* - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

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20 HKSA 200, paragraph 13(f).

21 For discussion of the diversity of governance structures, see paragraphs A1-A8 of HKSA 260, "Communication with Those Charged with Governance."

Uncertainty - A matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.

**Uncorrected misstatements* - Misstatements that the auditor has accumulated during the audit and that have not been corrected.

**Unmodified opinion* - The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.[22]

**User auditor* - An auditor who audits and reports on the financial statements of a user entity.

**User entity* - An entity that uses a service organization and whose financial statements are being audited.

Walk-through test - Involves tracing a few transactions through the financial reporting system.

**Written representation* - A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

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22 HKSA 700, paragraphs 35-36 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

HKSQC 1
Issued June 2009; revised July 2010

Effective as of 15 December 2009

Hong Kong Standard on Quality Control 1

Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements

(s) Suitably qualified external person – An individual outside the firm with the competence and capabilities to act as an engagement partner, for example, a partner of another firm, or an employee (with appropriate experience) of either a professional accountancy body whose members may perform audits and reviews of historical financial information, or other assurance or related services engagements, or of an organization that provides relevant quality control services.

Requirements

Applying, and Complying with, Relevant Requirements

13. Personnel within the firm responsible for establishing and maintaining the firm's system of quality control shall have an understanding of the entire text of this HKSQC, including its application and other explanatory material, to understand its objective and to apply its requirements properly.

14. The firm shall comply with each requirement of this HKSQC unless, in the circumstances of the firm, the requirement is not relevant to the services provided in respect of audits and reviews of financial statements, and other assurance and related services engagements. (Ref: Para. A1)

15. The requirements are designed to enable the firm to achieve the objective stated in this HKSQC. The proper application of the requirements is therefore expected to provide a sufficient basis for the achievement of the objective. However, because circumstances vary widely and all such circumstances cannot be anticipated, the firm shall consider whether there are particular matters or circumstances that require the firm to establish policies and procedures in addition to those required by this HKSQC to meet the stated objective.

Elements of a System of Quality Control

16. The firm shall establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:

    (a) Leadership responsibilities for quality within the firm.

    (b) Relevant ethical requirements.

    (c) Acceptance and continuance of client relationships and specific engagements.

    (d) Human resources.

    (e) Engagement performance.

    (f) Monitoring.

17. The firm shall document its policies and procedures and communicate them to the firm's personnel. (Ref: Para. A2-A3)

Leadership Responsibilities for Quality within the Firm

18. The firm shall establish policies and procedures designed to promote an internal culture recognizing that quality is essential in performing engagements. Such policies and procedures shall require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent) to assume ultimate responsibility for the firm's system of quality control. (Ref: Para. A4-A5)

(b) The firm to promptly communicate identified breaches of these policies and procedures to:

(i) The engagement partner who, with the firm, needs to address the breach; and

(ii) Other relevant personnel in the firm and, where appropriate, the network, and those subject to the independence requirements who need to take appropriate action; and

(c) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph 23(b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action.

24. At least annually, the firm shall obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant ethical requirements. (Ref: Para. A10-A11)

25. The firm shall establish policies and procedures: (Ref: Para. A10)

(a) Setting out criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and

(b) Requiring, for audits of financial statements of listed entities, the rotation of the engagement partner and the individuals responsible for engagement quality control review, and, where applicable, others subject to rotation requirements, after a specified period in compliance with relevant ethical requirements. (Ref: Para. A12-A17)

Acceptance and Continuance of Client Relationships and Specific Engagements

26. The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm:

(a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so; (Ref: Para. A18, A23)

(b) Can comply with relevant ethical requirements; and

(c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity. (Ref: Para. A19-A20, A23)

27. Such policies and procedures shall require:

(a) 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. (Ref: Para. A21, A23)

(b) If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm to determine whether it is appropriate to accept the engagement.

(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

Differences of Opinion

43. The firm shall establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted and, where applicable, between the engagement partner and the engagement quality control reviewer. (Ref: Para. A52-A53)

44. Such policies and procedures shall require that:

(a) Conclusions reached be documented and implemented; and

(b) The report not be dated until the matter is resolved.

Engagement Documentation

Completion of the Assembly of Final Engagement Files

45. The firm shall establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis after the engagement reports have been finalized. (Ref: Para. A54-A55)

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation

46. The firm shall establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility and retrievability of engagement documentation. (Ref: Para. A56-A59)

Retention of Engagement Documentation

47. The firm shall establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm or as required by law or regulation. (Ref: Para. A60-A63)

Monitoring

Monitoring the Firm's Quality Control Policies and Procedures

48. The firm shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. This process shall:

(a) Include an ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner;

(b) Require responsibility for the monitoring process to be assigned to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility; and

(c) Require that those performing the engagement or the engagement quality control review are not involved in inspecting the engagement. (Ref: Para. A64-A68)

Definition of "Firm," "Network" and "Network Firm" (Ref: Para. 20-25)

A10. The definitions of "firm," network" or "network firm" in relevant ethical requirements may differ from those set out in this HKSQC. For example, the Code[3] defines the "firm" as:

(a) A sole practitioner, partnership or corporation of professional accountants;

(b) An entity that controls such parties through ownership, management or other means; and

(c) An entity controlled by such parties through ownership, management or other means.

The Code also provides guidance in relation to the terms "network" and "network firm."

In complying with the requirements in paragraphs 20-25, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

Written Confirmation (Ref: Para. 24)

A11. Written confirmation may be in paper or electronic form. By obtaining confirmation and taking appropriate action on information indicating non-compliance, the firm demonstrates the importance that it attaches to independence and makes the issue current for, and visible to, its personnel.

Familiarity Threat (Ref: Para. 25)

A12. The Code discusses the familiarity threat that may be created by using the same senior personnel on an assurance engagement over a long period of time and the safeguards that might be appropriate to address such threats.

A13. Determining appropriate criteria to address familiarity threat may include matters such as:

- The nature of the engagement, including the extent to which it involves a matter of public interest; and
- The length of service of the senior personnel on the engagement.

Examples of safeguards include rotating the senior personnel or requiring an engagement quality control review.

A14. The Code recognizes that the familiarity threat is particularly relevant in the context of financial statement audits of listed entities. For these audits, the Code requires the rotation of the key audit partner[4] after a pre-defined period, normally no more than seven years, and provides related standards and guidance. National requirements may establish shorter rotation periods.

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[3] "HKICPA *Code of Ethics for Professional Accountants."*

[4] As defined in the HKICPA Code.

- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved.

Consultation (Ref: Para. 34)

A36. Consultation includes discussion at the appropriate professional level, with individuals within or outside the firm who have specialized expertise.

A37. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm's policies and procedures helps to promote a culture in which consultation is recognized as a strength and encourages personnel to consult on difficult or contentious matters.

A38. Effective consultation on significant technical, ethical and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- are given all the relevant facts that will enable them to provide informed advice; and
- have appropriate knowledge, seniority and experience,

and when conclusions resulting from consultations are appropriately documented and implemented.

A39. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.

Considerations Specific to Smaller Firms

A40. A firm needing to consult externally, for example, a firm without appropriate internal resources, may take advantage of advisory services provided by:

- Other firms;
- Professional and regulatory bodies; or
- Commercial organizations that provide relevant quality control services.

Before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

Engagement Quality Control Review

Criteria for an Engagement Quality Control Review (Ref: Para. 35(b))

A41. Criteria for determining which engagements, other than audits of financial statements of listed entities, are to be subject to an engagement quality control review may include, for example:

- The nature of the engagement, including the extent to which it involves a matter of public interest.
- The identification of unusual circumstances or risks in an engagement or class of engagements.
- Whether laws or regulations require an engagement quality control review.

Nature, Timing and Extent of the Engagement Quality Control Review (Ref: Para. 36-37)

A42. The engagement report is not dated until the completion of the engagement quality control review. However, documentation of the engagement quality control review may be completed after the date of the report.

A43. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the report.

A44. The extent of the engagement quality control review may depend, among other things, on the complexity of the engagement, whether the entity is a listed entity, and the risk that the report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner.

Engagement Quality Control Review of a Listed Entity (Ref: Para. 38)

A45. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of an audit of financial statements of a listed entity include:

- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of the financial statements of other entities as well as reviews of financial statements and other assurance and related services engagements.

- Determination of corrective actions to be taken and improvements to be made in the system, including the provision of feedback into the firm's policies and procedures relating to education and training.

- Communication to appropriate firm personnel of weaknesses identified in the system, in the level of understanding of the system, or compliance with it.

- Follow-up by appropriate firm personnel so that necessary modifications are promptly made to the quality control policies and procedures.

A66. Inspection cycle policies and procedures may, for example, specify a cycle that spans three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, such as the following:

- The size of the firm.

- The number and geographic location of offices.

- The results of previous monitoring procedures.

- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).

- The nature and complexity of the firm's practice and organization.

- The risks associated with the firm's clients and specific engagements.

A67. The inspection process includes the selection of individual engagements, some of which may be selected without prior notification to the engagement team. In determining the scope of the inspections, the firm may take into account the scope or conclusions of an independent external inspection program. However, an independent external inspection program does not act as a substitute for the firm's own internal monitoring program.

Considerations Specific to Smaller Firms

A68. In the case of small firms, monitoring procedures may need to be performed by individuals who are responsible for design and implementation of the firm's quality control policies and procedures, or who may be involved in performing the engagement quality control review. A firm with a limited number of persons may choose to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures. Alternatively, the firm may establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

Communicating Deficiencies (Ref: Para. 50)

A69. The reporting of identified deficiencies to individuals other than the relevant engagement partners need not include an identification of the specific engagements concerned, although there may be cases where such identification may be necessary for the proper discharge of the responsibilities of the individuals other than the engagement partners.

HKSA 200
Issued June 2009; revised July 2010

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

Hong Kong Standard on Auditing 200

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

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

6. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.[1] In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

7. The HKSAs contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The HKSAs require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:

   - Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
   - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
   - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

8. The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation. (Ref: Para. A12-A13)

9. The auditor may also have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, in relation to matters arising from the audit. These may be established by the HKSAs or by applicable law or regulation.[2]

Effective Date

10. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Overall Objectives of the Auditor

11. In conducting an audit of financial statements, the overall objectives of the auditor are:

    (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

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[1] HKSA 320, "Materiality in Planning and Performing an Audit" and HKSA 450, "Evaluation of Misstatements Identified during the Audit."

[2] See, for example, HKSA 260, "Communication with Those Charged with Governance;" and HKSA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraph 43.

(d) Auditor – The person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an HKSA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant.

(e) Detection risk – The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

(f) Financial statements – A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement.

(g) Historical financial information – Information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.

(h) Management – The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.

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

Where the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly, in all material respects, or to give a true and fair view.

(j) Premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit is conducted – That management and, where appropriate, those charged with governance have acknowledged and understand that they have the following responsibilities that are fundamental to the conduct of an audit in accordance with HKSAs. That is, responsibility:

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;

(ii) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(iii) To provide the auditor with:

Preparation of the Financial Statements (Ref: Para. 4)

A2. Law or regulation may establish the responsibilities of management and, where appropriate, those charged with governance in relation to financial reporting. However, the extent of these responsibilities, or the way in which they are described, may differ across jurisdictions. Despite these differences, an audit in accordance with HKSAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged and understand that they have responsibility:

(a) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;

(b) For such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(c) To provide the auditor with:

(i) Access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

(ii) Additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

A3. The preparation of the financial statements by management and, where appropriate, those charged with governance requires:

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.

- The preparation of the financial statements in accordance with that framework.

- The inclusion of an adequate description of that framework in the financial statements.

The preparation of the financial statements requires management to exercise judgment in making accounting estimates that are reasonable in the circumstances, as well as to select and apply appropriate accounting policies. These judgments are made in the context of the applicable financial reporting framework.

A4. The financial statements 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, "general purpose financial statements"); or

- The financial information needs of specific users (that is, "special purpose financial statements").

A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the HKSAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the HKSAs to the auditor's opinion cover both forms of opinion.

Ethical Requirements Relating to an Audit of Financial Statements (Ref: Para. 14)

A14. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise Parts A, B and D of the HKICPA's *Code of Ethics for Professional Accountants* (the Code) related to an audit of financial statements together with national requirements that are more restrictive.

A15. Part A of the Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles. The fundamental principles with which the auditor is required to comply by the Code are:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

Parts B and D of the Code illustrate how the conceptual framework is to be applied in specific situations.

A16. In the case of an audit engagement it is in the public interest and, therefore, required by the Code, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

A17. Hong Kong Standard on Quality Control (HKSQC) 1[9], or national requirements that are at least as demanding,[10] deal with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. 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, including those pertaining to independence.[11] HKSA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include remaining alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant

9 HKSQC 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements."

10 HKSA 220, "Quality Control for an Audit of Financial Statements," paragraph 2.

11 HKSQC 1, paragraphs 20-25.

ethical requirements by members of the engagement team, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement.[12] HKSA 220 recognizes that the engagement team is entitled to rely on a firm's system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

Professional Skepticism (Ref: Para. 15)

A18. Professional skepticism includes being alert to, for example:

- Audit evidence that contradicts other audit evidence obtained.
- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the HKSAs.

A19. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalizing when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

A20. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

A21. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.[13] In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the HKSAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.[14]

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[12] HKSA 220, paragraphs 9-12.

[13] HKSA 500, "Audit Evidence," paragraphs 7-9.

[14] HKSA 240, paragraph 13; HKSA 500, paragraph 11; HKSA 505, "External Confirmations," paragraphs 10-11, and 16.

A22. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: Para. 16)

A23. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the HKSAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

- Materiality and audit risk.
- The nature, timing and extent of audit procedures used to meet the requirements of the HKSAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the HKSAs and thereby, the overall objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

A24. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A25. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by HKSA 220,[15] assist the auditor in making informed and reasonable judgments.

A26. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A27. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit.[16] Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

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[15] HKSA 220, paragraph 18.

[16] HKSA 230, paragraph 8.

Risks of Material Misstatement

A34. The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

A35. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A36. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A37. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A38. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

A39. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The HKSAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.[18]

A40. The HKSAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in

[18] HKSA 330, "The Auditor's Reponses to Assessed Risks," paragraphs 7-17.

non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A41. HKSA 315 establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

Detection Risk

A42. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A43. Detection risk relates to the nature, timing and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

- adequate planning;
- proper assignment of personnel to the engagement team;
- the application of professional skepticism; and
- supervision and review of the audit work performed,

assist to enhance the effectiveness of an audit procedure and of its application and reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

A44. HKSA 300[19] and HKSA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

A45. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

- The nature of financial reporting;
- The nature of audit procedures; and
- The need for the audit to be conducted within a reasonable period of time and at a reasonable cost.

[19] HKSA 300, "Planning an Audit of Financial Statements."

A49. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;

- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and

- Use testing and other means of examining populations for misstatements.

A50. In light of the approaches described in paragraph A49, the HKSAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;[21] and

- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.[22]

Other Matters that Affect the Inherent Limitations of an Audit

A51. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion. See HKSA 240 for further discussion.

- The existence and completeness of related party relationships and transactions. See HKSA 550[23] for further discussion.

- The occurrence of non-compliance with laws and regulations. See HKSA 250[24] for further discussion.

- Future events or conditions that may cause an entity to cease to continue as a going concern. See HKSA 570[25] for further discussion.

Relevant HKSAs identify specific audit procedures to assist in mitigating the effect of the inherent limitations.

A52. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with HKSAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with HKSAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence. Whether the auditor has performed an audit in

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[21] HKSA 315, paragraphs 5-10.

[22] HKSA 330; HKSA 500; HKSA 520, "Analytical Procedures;" HKSA 530, "Audit Sampling."

[23] HKSA 550, "Related Parties."

[24] HKSA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements."

[25] HKSA 570, "Going Concern."

required to do something, *unless prohibited by law or regulation*. Depending on the jurisdiction, the legal or regulatory permission or prohibition may be explicit or implicit.

Departure from a Requirement (Ref: Para. 23)

A74. HKSA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement.[30] The HKSAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

Failure to Achieve an Objective (Ref: Para. 24)

A75. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the HKSAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the HKSAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an HKSA.
- Result in its not being practicable or possible for the auditor to carry out the additional audit procedures or obtain further audit evidence as determined necessary from the use of the objectives in accordance with paragraph 21, for example, due to a limitation in the available audit evidence.

A76. Audit documentation that meets the requirements of HKSA 230 and the specific documentation requirements of other relevant HKSAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

30 HKSA 230, paragraph 12.

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

Hong Kong Standard on Auditing 210

Agreeing the Terms of Audit Engagements

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Preconditions for an Audit

The Financial Reporting Framework (Ref: Para. 6(a))

A2. A condition for acceptance of an assurance engagement is that the criteria referred to in the definition of an assurance engagement are suitable and available to intended users.[9] Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Suitable criteria enable reasonably consistent evaluation or measurement of a subject matter within the context of professional judgment. For purposes of the HKSAs, the applicable financial reporting framework provides the criteria the auditor uses to audit the financial statements, including where relevant their fair presentation.

A3. Without an acceptable financial reporting framework, management does not have an appropriate basis for the preparation of the financial statements and the auditor does not have suitable criteria for auditing the financial statements. In many cases the auditor may presume that the applicable financial reporting framework is acceptable, as described in paragraphs A8-A9.

Determining the Acceptability of the Financial Reporting Framework

A4. Factors that are relevant to the auditor's determination of the acceptability of the financial reporting framework to be applied in the preparation of the financial statements include:

- The nature of the entity (for example, whether it is a business enterprise, a public sector entity or a not-for-profit organization);
- The purpose of the financial statements (for example, whether they are prepared to meet the common financial information needs of a wide range of users or the financial information needs of specific users);
- The nature of the financial statements (for example, whether the financial statements are a complete set of financial statements or a single financial statement); and
- Whether law or regulation prescribes the applicable financial reporting framework.

A5. Many users of financial statements are not in a position to demand financial statements tailored to meet their specific information needs. While all the information needs of specific users cannot be met, there are financial information needs that are common to a wide range of users. Financial statements prepared in accordance with a financial reporting framework designed to meet the common financial information needs of a wide range of users are referred to as general purpose financial statements.

A6. In some cases, the financial statements will be prepared in accordance with a financial reporting framework designed to meet the financial information needs of specific users. Such financial statements are referred to as special purpose financial statements. The financial information needs of the intended users will determine the applicable financial reporting framework in these circumstances. HKSA 800 discusses the acceptability of financial reporting frameworks designed to meet the financial information needs of specific users.[10]

[9] "Hong Kong Framework for Assurance Engagements," paragraph 17(b)(ii).

[10] HKSA 800, "Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks," paragraph 8.

HKSA 220
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Hong Kong Standard on Auditing 220

Quality Control for an Audit of Financial Statements

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

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the specific responsibilities of the auditor regarding quality control procedures for an audit of financial statements. It also addresses, where applicable, the responsibilities of the engagement quality control reviewer. This HKSA is to be read in conjunction with relevant ethical requirements.

System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. 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.[1]

   This HKSA is premised on the basis that the firm is subject to HKSQC 1 or to national requirements that are at least as demanding. (Ref: Para. A1)

3. Within the context of the firm's system of quality control, engagement teams have a responsibility to implement quality control procedures that are applicable to the audit engagement and provide the firm with relevant information to enable the functioning of that part of the firm's system of quality control relating to independence.

4. Engagement teams are entitled to rely on the firm's system of quality control, unless information provided by the firm or other parties suggests otherwise. (Ref: Para. A2)

Effective Date

5. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Objective

6. The objective of the auditor is to implement quality control procedures at the engagement level that provide the auditor with reasonable assurance that:

   (a) The audit complies with professional standards and applicable legal and regulatory requirements; and

   (b) The auditor's report issued is appropriate in the circumstances.

[1] HKSQC 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements," paragraph 11.

Definitions

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

   (a) Engagement partner[2] – The partner or other person in the firm who is responsible for the audit engagement and its performance, and for the auditor's report that is issued on behalf of the firm, and who, where required, has the appropriate authority from a professional, legal or regulatory body.

   (b) Engagement quality control review – A process designed to provide an objective evaluation, on or before the date of the auditor's report, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. The engagement quality control review process is for audits of financial statements of listed entities and those other audit engagements, if any, for which the firm has determined an engagement quality control review is required.

   (c) Engagement quality control reviewer – A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report.

   (d) Engagement team – All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor's external expert engaged by the firm or a network firm.[3]

   (e) Firm – A sole practitioner, partnership or corporation or other entity of professional accountants.

   (f) Inspection – In relation to completed audit engagements, procedures designed to provide evidence of compliance by engagement teams with the firm's quality control policies and procedures.

   (g) Listed entity – An entity whose shares, stock or debt are quoted or listed on a recognized stock exchange, or are marketed under the regulations of a recognized stock exchange or other equivalent body.

   (h) Monitoring – A process comprising an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements, designed to provide the firm with reasonable assurance that its system of quality control is operating effectively.

   (i) Network firm – A firm or entity that belongs to a network.

   (j) Network – A larger structure:

      (i) That is aimed at cooperation, and

[2] "Engagement partner," "partner," and "firm" should be read as referring to their public sector equivalents where relevant.

[3] HKSA 620, "Using the Work of an Auditor's Expert," paragraph 6(a), defines the term "auditor's expert."

(b) Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters, and the conclusions arising from those consultations; and

(c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached. (Ref: Para. A28-A31)

Differences of Opinion

22. If differences of opinion arise within the engagement team, with those consulted or, where applicable, between the engagement partner and the engagement quality control reviewer, the engagement team shall follow the firm's policies and procedures for dealing with and resolving differences of opinion.

Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A32-A34)

Documentation

24. The auditor shall include in the audit documentation: [4]

(a) Issues identified with respect to compliance with relevant ethical requirements and how they were resolved.

(b) Conclusions on compliance with independence requirements that apply to the audit engagement, and any relevant discussions with the firm that support these conclusions.

(c) Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements.

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A35)

25. The engagement quality control reviewer shall document, for the audit engagement reviewed, that:

(a) The procedures required by the firm's policies on engagement quality control review have been performed;

(b) The engagement quality control review has been completed on or before the date of the auditor's report; and

(c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions it reached were not appropriate.

[4] HKSA 230, "Audit Documentation," paragraphs 8-11, and A6.

Considerations Specific to Public Sector Entities

A7. Statutory measures may provide safeguards for the independence of public sector auditors. However, public sector auditors or audit firms carrying out public sector audits on behalf of the statutory auditor may, depending on the terms of the mandate in a particular jurisdiction, need to adapt their approach in order to promote compliance with the spirit of paragraph 11. This may include, where the public sector auditor's mandate does not permit withdrawal from the engagement, disclosure through a public report, of circumstances that have arisen that would, if they were in the private sector, lead the auditor to withdraw.

Acceptance and Continuance of Client Relationships and Audit Engagements (Ref: Para. 12)

A8. HKSQC 1 requires the firm to obtain information considered 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.[5] Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

- The integrity of the principal owners, key management and those charged with governance of the entity;
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources;
- Whether the firm and the engagement team can comply with relevant ethical requirements; and
- Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

Considerations Specific to Public Sector Entities (Ref: Para. 12-13)

A9. In the public sector, auditors may be appointed in accordance with statutory procedures. Accordingly, certain of the requirements and considerations regarding the acceptance and continuance of client relationships and audit engagements as set out in paragraphs 12, 13 and A8 may not be relevant. Nonetheless, information gathered as a result of the process described may be valuable to public sector auditors in performing risk assessments and in carrying out reporting responsibilities.

Assignment of Engagement Teams (Ref: Para. 14)

A10. An engagement team includes a person using expertise in a specialized area of accounting or auditing, whether engaged or employed by the firm, if any, who performs audit procedures on the engagement. However, a person with such expertise is not a member of the engagement team if that person's involvement with the engagement is only consultation. Consultations are addressed in paragraphs 18, A21 and A22.

A11. When considering the appropriate competence and capabilities expected of the engagement team as a whole, the engagement partner may take into consideration such matters as the team's:

- Understanding of, and practical experience with, audit engagements of a similar nature

5 HKSQC 1, paragraph 27(a).

A14. Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

A15. Supervision includes matters such as:

- Tracking the progress of the audit engagement.
- Considering the competence and capabilities of individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the audit engagement.
- Addressing significant matters arising during the audit engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members during the audit engagement.

Reviews

Review Responsibilities (Ref: Para. 16)

A16. Under HKSQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members.[7]

A17. A review consists of consideration whether, for example:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the auditor's report; and
- The objectives of the engagement procedures have been achieved.

The Engagement Partner's Review of Work Performed (Ref: Para. 17)

A18. Timely reviews of the following by the engagement partner at appropriate stages during the engagement allow significant matters to be resolved on a timely basis to the engagement partner's satisfaction on or before the date of the auditor's report:

- Critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement;

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[7] HKSQC 1, paragraph 33.

- Significant risks; and
- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by HKSA 230, the partner documents the extent and timing of the reviews.[8]

A19. An engagement partner taking over an audit during the engagement may apply the review procedures as described in paragraph A18 to review the work performed to the date of a change in order to assume the responsibilities of an engagement partner.

Considerations Relevant Where a Member of the Engagement Team with Expertise in a Specialized Area of Accounting or Auditing Is Used (Ref: Para. 15-17)

A20. Where a member of the engagement team with expertise in a specialized area of accounting or auditing is used, direction, supervision and review of that engagement team member's work may include matters such as:

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.
- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

Consultation (Ref: Para. 18)

A21. Effective consultation on significant technical, ethical and other matters within the firm or, where applicable, outside the firm can be achieved when those consulted:

- Are given all the relevant facts that will enable them to provide informed advice; and
- Have appropriate knowledge, seniority and experience.

A22. It may be appropriate for the engagement team to consult outside the firm, for example, where the firm lacks appropriate internal resources. They may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services.

Engagement Quality Control Review

Completion of the Engagement Quality Control Review before Dating of the Auditor's Report (Ref: Para. 19(c))

A23. HKSA 700 requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements.[9] In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

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[8] HKSA 230, paragraph 9(c).

[9] HKSA 700, "Forming an Opinion and Reporting on Financial Statements," paragraph 41.

A24. Conducting the engagement quality control review in a timely manner at appropriate stages during the engagement allows significant matters to be promptly resolved to the engagement quality control reviewer's satisfaction on or before the date of the auditor's report.

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph 22. Documentation of the engagement quality control review may be completed after the date of the auditor's report as part of the assembly of the final audit file. HKSA 230 establishes requirements and provides guidance in this regard.[10]

Nature, Timing and Extent of Engagement Quality Control Review (Ref: Para. 20)

A26. Remaining alert for changes in circumstances allows the engagement partner to identify situations in which an engagement quality control review is necessary, even though at the start of the engagement, such a review was not required.

A27. The extent of the engagement quality control review may depend, among other things, on the complexity of the audit engagement, whether the entity is a listed entity, and the risk that the auditor's report might not be appropriate in the circumstances. The performance of an engagement quality control review does not reduce the responsibilities of the engagement partner for the audit engagement and its performance.

Engagement Quality Control Review of Listed Entities (Ref: Para. 21)

A28. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with HKSA 315,[11] and the responses to those risks in accordance with HKSA 330,[12] including the engagement team's assessment of, and response to, the risk of fraud in accordance with HKSA 240.[13]
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

These other matters, depending on the circumstances, may also be applicable for engagement quality control reviews for audits of financial statements of other entities.

Considerations Specific to Smaller Entities (Ref: Para. 20-21)

A29. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for audit engagements that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

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10 HKSA 230, paragraphs 14-16.

11 HKSA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment."

12 HKSA 330, "The Auditor's Responses to Assessed Risks."

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

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Hong Kong Standard on Auditing 230

Audit Documentation

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Documentation of How Inconsistencies Have Been Addressed (Ref: Para. 11)

A15. The requirement to document how the auditor addressed inconsistencies in information does not imply that the auditor needs to retain documentation that is incorrect or superseded.

Considerations Specific to Smaller Entities (Ref. Para. 8)

A16. The audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity. Further, in the case of an audit where the engagement partner performs all the audit work, the documentation will not include matters that might have to be documented solely to inform or instruct members of an engagement team, or to provide evidence of review by other members of the team (for example, there will be no matters to document relating to team discussions or supervision). Nevertheless, the engagement partner complies with the overriding requirement in paragraph 8 to prepare audit documentation that can be understood by an experienced auditor, as the audit documentation may be subject to review by external parties for regulatory or other purposes.

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality determined in accordance with HKSA 320, [8] assessed risks, significant matters noted during the audit, and conclusions reached.

Departure from a Relevant Requirement (Ref: Para. 12)

A18. The requirements of the HKSAs are designed to enable the auditor to achieve the objectives specified in the HKSAs, and thereby the overall objectives of the auditor. Accordingly, other than in exceptional circumstances, the HKSAs call for compliance with each requirement that is relevant in the circumstances of the audit.

A19. The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant[9] 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[10] 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).

Matters Arising after the Date of the Auditor's Report (Ref: Para. 13)

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report. [11] The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in HKSA 220,[12] with the engagement partner taking final responsibility for the changes.

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8 HKSA 320, "Materiality in Planning and Performing an Audit."

9 HKSA 200, paragraph 22.

10 HKSA 610, "Using the Work of Internal Auditors."

11 HKSA 560, "Subsequent Events," paragraph 14.

12 HKSA 220, paragraph 16.

Appendix

(Ref: Para. 1)

Specific Audit Documentation Requirements in Other HKSAs

This appendix identifies paragraphs in other HKSAs in effect for audits of financial statements for periods beginning on or after 15 December 2009 that contain specific documentation requirements. The list is not a substitute for considering the requirements and related application and other explanatory material in HKSAs.

- HKSA 210, "Agreeing the Terms of Audit Engagements" – paragraphs 10-12
- HKSA 220, "Quality Control for an Audit of Financial Statements" – paragraphs 24-25
- HKSA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" – paragraphs 44-47
- HKSA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" – paragraph 29
- HKSA 260, "Communication with Those Charged with Governance" – paragraph 23
- HKSA 300, "Planning an Audit of Financial Statements" – paragraph 12
- HKSA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" – paragraph 32
- HKSA 320, "Materiality in Planning and Performing an Audit" – paragraph 14
- HKSA 330, "The Auditor's Responses to Assessed Risks" – paragraphs 28-30
- HKSA 450, "Evaluation of Misstatements Identified during the Audit" – paragraph 15
- HKSA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" – paragraph 23
- HKSA 550, "Related Parties" – paragraph 28
- HKSA 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)" – paragraph 50
- HKSA 610, "Using the Work of Internal Auditors" – paragraph 13

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Hong Kong Standard on Auditing 240

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

Hong Kong Institute of
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香港會計師公會

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to fraud in an audit of financial statements. Specifically, it expands on how HKSA 315[1] and HKSA 330[2] are to be applied in relation to risks of material misstatement due to fraud.

Characteristics of Fraud

2. Misstatements in the financial statements can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.

3. Although fraud is a broad legal concept, for the purposes of the HKSAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. (Ref: Para. A1-A6)

Responsibility for the Prevention and Detection of Fraud

4. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

Responsibilities of the Auditor

5. An auditor conducting an audit in accordance with HKSAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the HKSAs.[3]

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[1] HKSA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment."

[2] HKSA 330, "The Auditor's Responses to Assessed Risks."

[3] HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraphs A51-A52.

(b) Fraud risk factors – Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

Requirements

Professional Skepticism

12. In accordance with HKSA 200[5], the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)

13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)

14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Discussion among the Engagement Team

15. HKSA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion.[6] This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Risk Assessment Procedures and Related Activities

16. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, required by HKSA 315,[7] the auditor shall perform the procedures in paragraphs 17-24 to obtain information for use in identifying the risks of material misstatement due to fraud.

Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

    (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13)

    (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14)

    (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and

[5] HKSA 200, paragraph 15.

[6] HKSA 315, paragraph 10.

[7] HKSA 315, paragraphs 5-24.

(d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

18. The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)

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

Those Charged with Governance

20. Unless all of those charged with governance are involved in managing the entity,[8] the auditor shall obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks. (Ref: Para. A19-A21)

21. Unless all of those charged with governance are involved in managing the entity, the auditor shall make inquiries of those charged with governance to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate the responses to the inquiries of management.

Unusual or Unexpected Relationships Identified

22. The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.

Other Information

23. The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)

Evaluation of Fraud Risk Factors

24. The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)

Identification and Assessment of the Risks of Material Misstatement Due to Fraud

25. In accordance with HKSA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.[9]

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8 HKSA 260, "Communication with Those Charged with Governance," paragraph 13.

9 HKSA 315, paragraph 25.

26. When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)

27. The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

28. In accordance with HKSA 330, the auditor shall determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level.[10] (Ref: Para. A33)

29. In determining overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level, the auditor shall:

    (a) Assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement; (Ref: Para. A34-A35)

    (b) Evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings; and

    (c) Incorporate an element of unpredictability in the selection of the nature, timing and extent of audit procedures. (Ref: Para. A36)

Audit Procedures Responsive to Assessed Risks of Material Misstatement Due to Fraud at the Assertion Level

30. In accordance with HKSA 330, the auditor shall design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement due to fraud at the assertion level.[11] (Ref: Para. A37-A40)

Audit Procedures Responsive to Risks Related to Management Override of Controls

31. Management is in a unique position to perpetrate fraud because of management's ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such override could occur, it is a risk of material misstatement due to fraud and thus a significant risk.

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[10] HKSA 330, paragraph 5.

[11] HKSA 330, paragraph 6.

36. If the auditor identifies a misstatement, whether material or not, and the auditor has reason to believe that it is or may be the result of fraud and that management (in particular, senior management) is involved, the auditor shall reevaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. The auditor shall also consider whether circumstances or conditions indicate possible collusion involving employees, management or third parties when reconsidering the reliability of evidence previously obtained. (Ref: Para. A52)

37. If the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud the auditor shall evaluate the implications for the audit. (Ref: Para. A53)

Auditor Unable to Continue the Engagement

38. If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

    (a) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

    (b) Consider whether it is appropriate to withdraw from the engagement, where withdrawal is possible under applicable law or regulation; and

    (c) If the auditor withdraws:

        (i) Discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

        (ii) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal. (Ref: Para. A54-A57)

Written Representations

39. The auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

    (a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;

    (b) They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;

    (c) They have disclosed to the auditor their knowledge of fraud, or suspected fraud, affecting the entity involving:

        (i) Management;

        (ii) Employees who have significant roles in internal control; or

        (iii) Others where the fraud could have a material effect on the financial statements; and

(d) They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (Ref: Para. A58-A59)

Communications to Management and with Those Charged with Governance

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A60)

41. Unless all of those charged with governance are involved in managing the entity, if the auditor has identified or suspects fraud involving:

    (a) management;

    (b) employees who have significant roles in internal control; or

    (c) others where the fraud results in a material misstatement in the financial statements,

    the auditor shall communicate these matters to those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions to those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. (Ref: Para. A61-A63)

42. The auditor shall communicate with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A64)

Communications to Regulatory and Enforcement Authorities[11a]

43. If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. Although the auditor's professional duty to maintain the confidentiality of client information may preclude such reporting, the auditor's legal responsibilities may override the duty of confidentiality in some circumstances. (Ref: Para. A65-A67)

Documentation

44. The auditor shall include the following in the audit documentation[12] of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by HKSA 315:[13]

    (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and

    (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

45. The auditor shall include the following in the audit documentation of the auditor's responses to the assessed risks of material misstatement required by HKSA 330:[14]

[11a] Additional local guidance is provided in Appendix 4.

[12] HKSA 230, "Audit Documentation," paragraphs 8-11, and paragraph A6.

[13] HKSA 315, paragraph 32.

[14] HKSA 330, paragraph 28.

collateral for a personal loan or a loan to a related party).

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorization.

Considerations Specific to Public Sector Entities

A6. The public sector auditor's responsibilities relating to fraud may be a result of law, regulation or other authority applicable to public sector entities or separately covered by the auditor's mandate. Consequently, the public sector auditor's responsibilities may not be limited to consideration of risks of material misstatement of the financial statements, but may also include a broader responsibility to consider risks of fraud.

Professional Skepticism (Ref: Para. 12-14)

A7. Maintaining professional skepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist. It includes considering the reliability of the information to be used as audit evidence and the controls over its preparation and maintenance where relevant. Due to the characteristics of fraud, the auditor's professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

A8. Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's professional skepticism is particularly important in considering the risks of material misstatement due to fraud because there may have been changes in circumstances.

A9. An audit performed in accordance with HKSAs rarely involves the authentication of documents, nor is the auditor trained as or expected to be an expert in such authentication.[15] However, when the auditor identifies conditions that cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, possible procedures to investigate further may include:

- Confirming directly with the third party.
- Using the work of an expert to assess the document's authenticity.

Discussion among the Engagement Team (Ref: Para. 15)

A10. Discussing the susceptibility of the entity's financial statements to material misstatement due to fraud with the engagement team:

- Provides an opportunity for more experienced engagement team members to share their insights about how and where the financial statements may be susceptible to material misstatement due to fraud.
- Enables the auditor to consider an appropriate response to such susceptibility and to determine which members of the engagement team will conduct certain audit procedures.
- Permits the auditor to determine how the results of audit procedures will be shared among the engagement team and how to deal with any allegations of fraud that may come to the auditor's attention.

[15] HKSA 200, paragraph A47.

Considerations specific to smaller entities

A13. In some entities, particularly smaller entities, the focus of management's assessment may be on the risks of employee fraud or misappropriation of assets.

Management's Process for Identifying and Responding to the Risks of Fraud (Ref: Para. 17(b))

A14. In the case of entities with multiple locations management's processes may include different levels of monitoring of operating locations, or business segments. Management may also have identified particular operating locations or business segments for which a risk of fraud may be more likely to exist.

Inquiry of Management and Others within the Entity (Ref: Para. 18)

A15. The auditor's inquiries of management may provide useful information concerning the risks of material misstatements in the financial statements resulting from employee fraud. However, such inquiries are unlikely to provide useful information regarding the risks of material misstatement in the financial statements resulting from management fraud. Making inquiries of others within the entity may provide individuals with an opportunity to convey information to the auditor that may not otherwise be communicated.

A16. Examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud include:

- Operating personnel not directly involved in the financial reporting process.
- Employees with different levels of authority.
- Employees involved in initiating, processing or recording complex or unusual transactions and those who supervise or monitor such employees.
- In-house legal counsel.
- Chief ethics officer or equivalent person.
- The person or persons charged with dealing with allegations of fraud.

A17. Management is often in the best position to perpetrate fraud. Accordingly, when evaluating management's responses to inquiries with an attitude of professional skepticism, the auditor may judge it necessary to corroborate responses to inquiries with other information.

Inquiry of Internal Audit (Ref: Para. 19)

A18. HKSA 315 and HKSA 610 establish requirements and provide guidance in audits of those entities that have an internal audit function.[16] In carrying out the requirement of those HKSAs in the context of fraud, the auditor may inquire about specific internal audit activities including, for example:

- The procedures performed, if any, by the internal auditors during the year to detect fraud.
- Whether management has satisfactorily responded to any findings resulting from those procedures.

[16] HKSA 315, paragraph 23, and HKSA 610, "Using the Work of Internal Auditors."

Obtaining an Understanding of Oversight Exercised by Those Charged with Governance (Ref: Para. 20)

A19. Those charged with governance of an entity oversee the entity's systems for monitoring risk, financial control and compliance with the law. In many countries, corporate governance practices are well developed and those charged with governance play an active role in oversight of the entity's assessment of the risks of fraud and of the relevant internal control. Since the responsibilities of those charged with governance and management may vary by entity and by country, it is important that the auditor understands their respective responsibilities to enable the auditor to obtain an understanding of the oversight exercised by the appropriate individuals.[17]

A20. An understanding of the oversight exercised by those charged with governance may provide insights regarding the susceptibility of the entity to management fraud, the adequacy of internal control over risks of fraud, and the competency and integrity of management. The auditor may obtain this understanding in a number of ways, such as by attending meetings where such discussions take place, reading the minutes from such meetings or making inquiries of those charged with governance.

Considerations Specific to Smaller Entities

A21. In some cases, all of those charged with governance are involved in managing the entity. This may be the case in a small entity where a single owner manages the entity and no one else has a governance role. In these cases, there is ordinarily no action on the part of the auditor because there is no oversight separate from management.

Consideration of Other Information (Ref: Para. 23)

A22. In addition to information obtained from applying analytical procedures, other information obtained about the entity and its environment may be helpful in identifying the risks of material misstatement due to fraud. The discussion among team members may provide information that is helpful in identifying such risks. In addition, information obtained from the auditor's client acceptance and retention processes, and experience gained on other engagements performed for the entity, for example, engagements to review interim financial information, may be relevant in the identification of the risks of material misstatement due to fraud.

Evaluation of Fraud Risk Factors (Ref: Para. 24)

A23. The fact that fraud is usually concealed can make it very difficult to detect. Nevertheless, the auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). For example:

- The need to meet expectations of third parties to obtain additional equity financing may create pressure to commit fraud;
- The granting of significant bonuses if unrealistic profit targets are met may create an incentive to commit fraud; and
- A control environment that is not effective may create an opportunity to commit fraud.

A24. Fraud risk factors cannot easily be ranked in order of importance. The significance of fraud risk factors varies widely. Some of these factors will be present in entities where the specific conditions do not present risks of material misstatement. Accordingly, the determination of

[17] HKSA 260, paragraphs A1-A8, discuss with whom the auditor communicates when the entity's governance structure is not well defined.

A29. The risks of fraud in revenue recognition may be greater in some entities than others. For example, there may be pressures or incentives on management to commit fraudulent financial reporting through inappropriate revenue recognition in the case of listed entities when, for example, performance is measured in terms of year over year revenue growth or profit. Similarly, for example, there may be greater risks of fraud in revenue recognition in the case of entities that generate a substantial portion of revenues through cash sales.

A30. The presumption that there are risks of fraud in revenue recognition may be rebutted. For example, the auditor may conclude that there is no risk of material misstatement due to fraud relating to revenue recognition in the case where there is a single type of simple revenue transaction, for example, leasehold revenue from a single unit rental property.

Identifying and Assessing the Risks of Material Misstatement Due to Fraud and Understanding the Entity's Related Controls (Ref: Para. 27)

A31. 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.[18] In determining which controls to implement to prevent and detect fraud, management considers the risks that the financial statements may be materially misstated as a result of fraud. As part of this consideration, management may conclude that it is not cost effective to implement and maintain a particular control in relation to the reduction in the risks of material misstatement due to fraud to be achieved.

A32. It is therefore important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud. In doing so, the auditor may learn, for example, that management has consciously chosen to accept the risks associated with a lack of segregation of duties. Information from obtaining this understanding may also be useful in identifying fraud risks factors that may affect the auditor's assessment of the risks that the financial statements may contain material misstatement due to fraud.

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 28)

A33. Determining overall responses to address the assessed risks of material misstatement due to fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through:

- Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions.
- Increased recognition of the need to corroborate management explanations or representations concerning material matters.

It also involves more general considerations apart from the specific procedures otherwise planned; these considerations include the matters listed in paragraph 29, which are discussed below.

Assignment and Supervision of Personnel (Ref: Para. 29(a))

A34. The auditor may respond to identified risks of material misstatement due to fraud by, for example, assigning additional individuals with specialized skill and knowledge, such as forensic and IT experts, or by assigning more experienced individuals to the engagement.

[18] HKSA 315, paragraph A48.

or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.

A46. The purpose of performing a retrospective review of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year is to determine whether there is an indication of a possible bias on the part of management. It is not intended to call into question the auditor's professional judgments made in the prior year that were based on information available at the time.

A47. A retrospective review is also required by HKSA 540.[19] That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's prior period estimation process, audit evidence about the outcome, or where applicable, the subsequent re-estimation of prior period accounting estimates that is pertinent to making current period accounting estimates, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor's review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this HKSA may be carried out in conjunction with the review required by HKSA 540.

Business Rationale for Significant Transactions (Ref: Para. 32(c))

A48. Indicators that may suggest that significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual, may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets include:

- The form of such transactions appears overly complex (for example, the transaction involves multiple entities within a consolidated group or multiple unrelated third parties).
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity, and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities, have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Evaluation of Audit Evidence (Ref: Para. 34-37)

A49. HKSA 330 requires the auditor, based on the audit procedures performed and the audit evidence obtained, to evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate.[20] This evaluation is primarily a qualitative matter based on the auditor's judgment. Such an evaluation may provide further insight about the risks of material misstatement due to fraud and whether there is a need to perform additional or different audit procedures. Appendix 3 contains examples of circumstances that may indicate the possibility of fraud.

[19] HKSA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures," paragraph 9.

[20] HKSA 330, paragraph 25.

Analytical Procedures Performed Near the End of the Audit in Forming an Overall Conclusion (Ref: Para. 34)

A50. Determining which particular trends and relationships may indicate a risk of material misstatement due to fraud requires professional judgment. Unusual relationships involving year-end revenue and income are particularly relevant. These might include, for example: uncharacteristically large amounts of income being reported in the last few weeks of the reporting period or unusual transactions; or income that is inconsistent with trends in cash flow from operations.

Consideration of Identified Misstatements (Ref: Para. 35-37)

A51. Since fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so or some rationalization of the act, an instance of fraud is unlikely to be an isolated occurrence. Accordingly, misstatements, such as numerous misstatements at a specific location even though the cumulative effect is not material, may be indicative of a risk of material misstatement due to fraud.

A52. The implications of identified fraud depend on the circumstances. For example, an otherwise insignificant fraud may be significant if it involves senior management. In such circumstances, the reliability of evidence previously obtained may be called into question, since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. There may also be a possibility of collusion involving employees, management or third parties.

A53. HKSA 450[21] and HKSA 700[22] establish requirements and provide guidance on the evaluation and disposition of misstatements and the effect on the auditor's opinion in the auditor's report.

Auditor Unable to Continue the Engagement (Ref: Para. 38)

A54. Examples of exceptional circumstances that may arise and that may bring into question the auditor's ability to continue performing the audit include:

(a) The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the financial statements;

(b) The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or

(c) The auditor has significant concern about the competence or integrity of management or those charged with governance.

A55. Because of the variety of the circumstances that may arise, it is not possible to describe definitively when withdrawal from an engagement is appropriate. Factors that affect the auditor's conclusion include the implications of the involvement of a member of management or of those charged with governance (which may affect the reliability of management representations) and the effects on the auditor of a continuing association with the entity.

A56. The auditor has professional and legal responsibilities in such circumstances and these responsibilities may vary by country. In some countries, for example, the auditor may be entitled to, or required to, make a statement or report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities. Given the exceptional nature of the circumstances and the need to consider the legal requirements, the auditor may consider

[21] HKSA 450, "Evaluation of Misstatements Identified during the Audit."

[22] HKSA 700, "Forming an Opinion and Reporting on Financial Statements."

it appropriate to seek legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibility of reporting to shareholders, regulators or others.[23]

Considerations Specific to Public Sector Entities

A57. In many cases in the public sector, the option of withdrawing from the engagement may not be available to the auditor due to the nature of the mandate or public interest considerations.

Written Representations (Ref: Para. 39)

A58. HKSA 580[24] establishes requirements and provides guidance on obtaining appropriate representations from management and, where appropriate, those charged with governance in the audit. In addition to acknowledging that they have fulfilled their responsibility for the preparation of the financial statements, it is important that, irrespective of the size of the entity, management and, where appropriate, those charged with governance acknowledge their responsibility for internal control designed, implemented and maintained to prevent and detect fraud.

A59. Because of the nature of fraud and the difficulties encountered by auditors in detecting material misstatements in the financial statements resulting from fraud, it is important that the auditor obtain a written representation from management and, where appropriate, those charged with governance confirming that they have disclosed to the auditor:

(a) The results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud; and

(b) Their knowledge of actual, suspected or alleged fraud affecting the entity.

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

A60. When the auditor has obtained evidence that fraud exists or may exist, it is important that the matter be brought to the attention of the appropriate level of management as soon as practicable. This is so even if the matter might be considered inconsequential (for example, a minor defalcation by an employee at a low level in the entity's organization). The determination of which level of management is the appropriate one is a matter of professional judgment and is affected by such factors as the likelihood of collusion and the nature and magnitude of the suspected fraud. Ordinarily, the appropriate level of management is at least one level above the persons who appear to be involved with the suspected fraud.

Communication with Those Charged with Governance (Ref: Para. 41)

A61. The auditor's communication with those charged with governance may be made orally or in writing. HKSA 260 identifies factors the auditor considers in determining whether to communicate orally or in writing.[25] Due to the nature and sensitivity of fraud involving senior management, or fraud that results in a material misstatement in the financial statements, the auditor reports such matters on a timely basis and may consider it necessary to also report such matters in writing.

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[23] The HKICPA *Code of Ethics for Professional Accountants* provides guidance on communications with an auditor replacing the existing auditor.

[24] HKSA 580, "Written Representations."

[25] HKSA 260, paragraph A38.

- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.

- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity.

- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.[1]

- Personal guarantees of debts of the entity.

There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.

- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.

- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.

- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions.

- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.

- Use of business intermediaries for which there appears to be no clear business justification.

- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

The monitoring of management is not effective as a result of the following:

- Domination of management by a single person or small group (in a non owner-managed business) without compensating controls.

- Oversight by those charged with governance over the financial reporting process and internal control is not effective.

[1] Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.

HKSA 250
Issued July 2009; revised July 2010

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

Hong Kong Standard on Auditing 250

Consideration of Laws and Regulations in an Audit of Financial Statements

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

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to consider laws and regulations in an audit of financial statements. This HKSA does not apply to other assurance engagements in which the auditor is specifically engaged to test and report separately on compliance with specific laws or regulations.

Effect of Laws and Regulations

2. The effect on financial statements of laws and regulations varies considerably. Those laws and regulations to which an entity is subject constitute the legal and regulatory framework. The provisions of some laws or regulations have a direct effect on the financial statements in that they determine the reported amounts and disclosures in an entity's financial statements. Other laws or regulations are to be complied with by management or set the provisions under which the entity is allowed to conduct its business but do not have a direct effect on an entity's financial statements. Some entities operate in heavily regulated industries (such as banks and chemical companies). Others are subject only to the many laws and regulations that relate generally to the operating aspects of the business (such as those related to occupational safety and health, and equal employment opportunity). Non-compliance with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

Responsibility for Compliance with Laws and Regulations (Ref: Para. A1-A6)

3. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, including compliance with the provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

Responsibility of the Auditor

4. The requirements in this HKSA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

5. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.[1] In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the HKSAs.[2] In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

   - There are many laws and regulations, relating principally to the operating aspects of an entity, that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

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[1] HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraph 5.

[2] HKSA 200, paragraphs A51-A52.

(b) To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements; and

(c) To respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

Definition

11. For the purposes of this HKSA, the following term has the meaning attributed below:

Non-compliance – Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

Requirements

The Auditor's Consideration of Compliance with Laws and Regulations

12. As part of obtaining an understanding of the entity and its environment in accordance with HKSA 315,[4] the auditor shall obtain a general understanding of:

(a) The legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates; and

(b) How the entity is complying with that framework. (Ref: Para. A7)

13. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. (Ref: Para. A8)

14. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements: (Ref: Para. A9-A10)

(a) Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and

(b) Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.

15. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. (Ref: Para. A11)

16. The auditor shall request management and, where appropriate, those charged with governance, to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (Ref: Para. A12)

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[4] HKSA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment," paragraph 11.

Reporting Non-Compliance in the Auditor's Report on the Financial Statements

25. If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been adequately reflected in the financial statements, the auditor shall, in accordance with HKSA 705, express a qualified opinion or an adverse opinion on the financial statements. [6]

26. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with HKSA 705.

27. If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by the circumstances rather than by management or those charged with governance, the auditor shall evaluate the effect on the auditor's opinion in accordance with HKSA 705.

Reporting Non-Compliance to Regulatory and Enforcement Authorities

28. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. (Ref: Para. A19-A20)

Documentation

29. The auditor shall include in the audit documentation identified or suspected non-compliance with laws and regulations and the results of discussion with management and, where applicable, those charged with governance and other parties outside the entity.[7] (Ref: Para. A21)

Conformity and Compliance with International Standards on Auditing

30. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 250, "Consideration of Laws and Regulations in an Audit of Financial Statements". Compliance with the requirements of this HKSA ensures compliance with ISA 250.

31. Additional local explanation is provided in footnote 12.

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Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations (Ref: Para. 3-8)

A1. It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with laws and regulations. Laws and regulations may affect an entity's financial statements in different ways: for example, most directly, they may affect specific disclosures required of the entity in the financial statements or they may prescribe the applicable financial reporting framework. They may also establish certain legal rights and obligations of the entity, some of which will be recognized in the entity's financial statements. In addition, laws and regulations may impose penalties in cases of non-compliance.

[6] HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report," paragraphs 7-8.

[7] HKSA 230, "Audit Documentation," paragraphs 8-11, and A6.

Evaluating the Implications of Non-Compliance (Ref: Para. 21)

A17. As required by paragraph 21, the auditor evaluates the implications of non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular instances of non-compliance identified by the auditor will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or employees involved, especially implications arising from the involvement of the highest authority within the entity.

A18. In exceptional cases, the auditor may consider whether withdrawal from the engagement, where withdrawal is possible under applicable law or regulation, is necessary when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances, even when the non-compliance is not material to the financial statements. When deciding whether withdrawal from the engagement is necessary, the auditor may consider seeking legal advice. If withdrawal from the engagement is not possible, the auditor may consider alternative actions, including describing the non-compliance in an Other Matter paragraph in the auditor's report.[11]

Reporting of Identified or Suspected Non-Compliance

Reporting Non-Compliance to Regulatory and Enforcement Authorities (Ref: Para. 28)

A19. The auditor's professional duty to maintain the confidentiality of client information may preclude reporting identified or suspected non-compliance with laws and regulations to a party outside the entity. However, the auditor's legal responsibilities vary by jurisdiction and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law.[12] In some jurisdictions, the auditor of a financial institution has a statutory duty to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to supervisory authorities. Also, in some jurisdictions, the auditor has a duty to report misstatements to authorities in those cases where management and, where applicable, those charged with governance fail to take corrective action. The auditor may consider it appropriate to obtain legal advice to determine the appropriate course of action.

Considerations Specific to Public Sector Entities

A20. A public sector auditor may be obliged to report on instances of non-compliance to the legislature or other governing body or to report them in the auditor's report.

Documentation (Ref: Para. 29)

A21. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

- Copies of records or documents.
- Minutes of discussions held with management, those charged with governance or parties outside the entity.

[11] HKSA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report," paragraph 8.

[12] Additional guidance is provided in Appendix 4 of HKSA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements".

HKSA 260
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Effective for audits of financial statements
for periods beginning on or after 15 December 2009

Hong Kong Standard on Auditing 260

Communication with Those Charged with Governance

Hong Kong Institute of
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Adequacy of the Communication Process

22. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A42-A44)

Documentation

23. Where matters required by this HKSA to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.[2] (Ref: Para. A45)

Conformity and Compliance with International Standards on Auditing

24. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 260, "Communication with Those Charged with Governance". Compliance with the requirements of this HKSA ensures compliance with ISA 260.

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Application and Other Explanatory Material

Those Charged with Governance (Ref: Para. 11)

A1. Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. For example:

- In some jurisdictions, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a "two-tier board" structure). In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a "one-tier board" structure).

- In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government entities, a body that is not part of the entity is charged with governance.

- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.

- In some cases, those charged with governance are responsible for approving[3] the entity's financial statements (in other cases management has this responsibility).

2 HKSA 230, "Audit Documentation," paragraphs 8-11, and paragraph A6.

3 As described at paragraph A40 of HKSA 700, "Forming an Opinion and Reporting on Financial Statements," having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

A2. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, for example, the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities. Alternatively, a subgroup or individual may have specific, legally identified responsibilities that differ from those of the governing body.

A3. Such diversity means that it is not possible for this HKSA to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. In such cases, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes obtained in accordance with HKSA 315[4] is relevant. The appropriate person(s) with whom to communicate may vary depending on the matter to be communicated.

A4. HKSA 600 includes specific matters to be communicated by group auditors with those charged with governance.[5] When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (for example, common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

Communication with a Subgroup of Those Charged with Governance (Ref: Para. 12)

A5. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

[4] HKSA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment."

[5] HKSA 600, "Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)," paragraphs 46-49.

- It may be appropriate to communicate a significant difficulty 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. Similarly, the auditor may communicate orally to those charged with governance as soon as practicable significant deficiencies in internal control that the auditor has identified, prior to communicating these in writing as required by HKSA 265. [9]

- Communications regarding independence may be appropriate whenever significant judgments are made about threats to independence and related safeguards, for example, when accepting an engagement to provide non-audit services, and at a concluding discussion. A concluding discussion may also be an appropriate time to communicate findings from the audit, including the auditor's views about the qualitative aspects of the entity's accounting practices.

- When auditing both general purpose and special purpose financial statements, it may be appropriate to coordinate the timing of communications.

A41. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.

- Any legal obligation to communicate certain matters within a specified timeframe.

- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.

- The time at which the auditor identifies certain matters, for example, the auditor may not identify a particular matter (for example, noncompliance with a law) in time for preventive action to be taken, but communication of the matter may enable remedial action to be taken.

Adequacy of the Communication Process (Ref: Para. 22)

A42. The auditor need not design specific procedures to support the evaluation of the two-way communication between the auditor and those charged with governance; rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters raised by the auditor. Where significant matters raised in previous communications have not been dealt with effectively, it may be appropriate for the auditor to inquire as to why appropriate action has not been taken, and to consider raising the point again. This avoids the risk of giving an impression that the auditor is satisfied that the matter has been adequately addressed or is no longer significant.

- The apparent openness of those charged with governance in their communications with the auditor.

- The willingness and capacity of those charged with governance to meet with the auditor without management present.

[9] HKSA 265, paragraphs 9 and A14.

Appendix 1

(Ref: Para. 3)

Specific Requirements in HKSQC 1 and Other HKSAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in HKSQC 1[1] and other HKSAs in effect for audits of financial statements for periods beginning on or after 15 December 2009 that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in HKSAs.

- HKSQC 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements" – paragraph 30(a)
- HKSA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" – paragraphs 21, 38(c)(i) and 40-42
- HKSA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" – paragraphs 14, 19 and 22-24
- HKSA 265, "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" – paragraph 9
- HKSA 450, "Evaluation of Misstatements Identified during the Audit" – paragraphs 12-13
- HKSA 505, "External Confirmations" – paragraph 9
- HKSA 510, "Initial Audit Engagements — Opening Balances" – paragraph 7
- HKSA 550, "Related Parties" – paragraph 27
- HKSA 560, "Subsequent Events" – paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17
- HKSA 570, "Going Concern" – paragraph 23
- HKSA 600, "Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)" – paragraph 49
- HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report" – paragraphs 12, 14, 19(a) and 28
- HKSA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report" – paragraph 9
- HKSA 710, "Comparative Information — Corresponding Figures and Comparative Financial Statements" – paragraph 18
- HKSA 720, "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements" – paragraphs 10, 13 and 16

1 HKSQC 1, "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements."

Appendix 2

(Ref: Para. 16(a), A17)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraph A17, may include such matters as:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, having regard to the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant accounting policies as well as information on accounting policies used by similar entities.

- The initial selection of, and changes in significant accounting policies, including the application of new accounting pronouncements. The communication may include: the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.

- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).

- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in HKSA 540,[1] including, for example:

  - Management's identification of accounting estimates.

  - Management's process for making accounting estimates.

  - Risks of material misstatement.

  - Indicators of possible management bias.

  - Disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (for example, disclosures related to revenue recognition, remuneration, going concern, subsequent events, and contingency issues).

- The overall neutrality, consistency, and clarity of the disclosures in the financial statements.

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1 HKSA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

HKSA 265
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Effective for audits of financial statements
for periods beginning on or after 15 December 2009

Hong Kong Standard on Auditing 265

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

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matters as being generally equivalent to the significant deficiencies required by this HKSA to be communicated to those charged with governance.

A11. The requirements of this HKSA remain applicable notwithstanding that law or regulation may require the auditor to use specific terms or definitions.

Communication of Deficiencies in Internal Control

Communication of Significant Deficiencies in Internal Control to Those Charged with Governance (Ref: Para. 9)

A12. Communicating significant deficiencies in writing to those charged with governance reflects the importance of these matters, and assists those charged with governance in fulfilling their oversight responsibilities. HKSA 260 establishes relevant considerations regarding communication with those charged with governance when all of them are involved in managing the entity.[6]

A13. In determining when to issue the written communication, the auditor may consider whether receipt of such communication would be an important factor in enabling those charged with governance to discharge their oversight responsibilities. In addition, for listed entities in certain jurisdictions, those charged with governance may need to receive the auditor's written communication before the date of approval of the financial statements in order to discharge specific responsibilities in relation to internal control for regulatory or other purposes. For other entities, the auditor may issue the written communication at a later date. Nevertheless, in the latter case, as the auditor's written communication of significant deficiencies forms part of the final audit file, the written communication is subject to the overriding requirement[7] for the auditor to complete the assembly of the final audit file on a timely basis. HKSA 230 states that an appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.[8]

A14. Regardless of the timing of the written communication of significant deficiencies, the auditor may communicate these orally in the first instance to management and, when appropriate, to those charged with governance to assist them in taking timely remedial action to minimize the risks of material misstatement. Doing so, however, does not relieve the auditor of the responsibility to communicate the significant deficiencies in writing, as this HKSA requires.

A15. The level of detail at which to communicate significant deficiencies is a matter of the auditor's professional judgment in the circumstances. Factors that the auditor may consider in determining an appropriate level of detail for the communication include, for example:

- The nature of the entity. For example, the communication required for a public interest entity may be different from that for a non-public interest entity.
- The size and complexity of the entity. For example, the communication required for a complex entity may be different from that for an entity operating a simple business.
- The nature of significant deficiencies that the auditor has identified.

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6 HKSA 260, paragraph 13.

7 HKSA 230, "Audit Documentation," paragraph 14.

8 HKSA 230, paragraph A21.

- The entity's governance composition. For example, more detail may be needed if those charged with governance include members who do not have significant experience in the entity's industry or in the affected areas.

- Legal or regulatory requirements regarding the communication of specific types of deficiency in internal control.

A16. Management and those charged with governance may already be aware of significant deficiencies that the auditor has identified during the audit and may have chosen not to remedy them because of cost or other considerations. The responsibility for evaluating the costs and benefits of implementing remedial action rests with management and those charged with governance. Accordingly, the requirement in paragraph 9 applies regardless of cost or other considerations that management and those charged with governance may consider relevant in determining whether to remedy such deficiencies.

A17. The fact that the auditor communicated a significant deficiency to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication if remedial action has not yet been taken. If a previously communicated significant deficiency remains, the current year's communication may repeat the description from the previous communication, or simply reference the previous communication. The auditor may ask management or, where appropriate, those charged with governance, why the significant deficiency has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency.

Considerations Specific to Smaller Entities

A18. In the case of audits of smaller entities, the auditor may communicate in a less structured manner with those charged with governance than in the case of larger entities.

Communication of Deficiencies in Internal Control to Management (Ref: Para. 10)

A19. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the deficiencies in internal control and to take the necessary remedial action. For significant deficiencies, the appropriate level is likely to be the chief executive officer or chief financial officer (or equivalent) as these matters are also required to be communicated to those charged with governance. For other deficiencies in internal control, the appropriate level may be operational management with more direct involvement in the control areas affected and with the authority to take appropriate remedial action.

Communication of Significant Deficiencies in Internal Control to Management (Ref: Para. 10(a))

A20. Certain identified significant deficiencies in internal control may call into question the integrity or competence of management. For example, there may be evidence of fraud or intentional non-compliance with laws and regulations by management, or management may exhibit an inability to oversee the preparation of adequate financial statements that may raise doubt about management's competence. Accordingly, it may not be appropriate to communicate such deficiencies directly to management.

A21. HKSA 250 establishes requirements and provides guidance on the reporting of identified or suspected non-compliance with laws and regulations, including when those charged with governance are themselves involved in such non-compliance.[9] HKSA 240 establishes

[9] HKSA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements," paragraphs 22-28.

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Hong Kong Standard on Auditing 300

Planning an Audit of Financial Statements

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11. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A14-A15)

Documentation

12. The auditor shall include in the audit documentation:[6]

    (a) The overall audit strategy;

    (b) The audit plan; and

    (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A16-A19)

Additional Considerations in Initial Audit Engagements

13. The auditor shall undertake the following activities prior to starting an initial audit:

    (a) Performing procedures required by HKSA 220 regarding the acceptance of the client relationship and the specific audit engagement;[7] and

    (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A20)

Conformity and Compliance with International Standards on Auditing

14. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 300, "Planning an Audit of Financial Statements". Compliance with the requirements of this HKSA ensures compliance with ISA 300.

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Application and Other Explanatory Material

The Role and Timing of Planning (Ref: Para. 2)

A1. The nature and extent of planning activities will vary according to the size and complexity of the entity, the key engagement team members' previous experience with the entity, and changes in circumstances that occur during the audit engagement.

A2. Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement. Planning, however, includes consideration of the timing of certain activities and audit procedures that need to be completed prior to the performance of further audit procedures. For example, planning includes the need to consider, prior to the auditor's identification and assessment of the risks of material misstatement, such matters as:

- The analytical procedures to be applied as risk assessment procedures.

- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

[6] HKSA 230, "Audit Documentation," paragraphs 8-11, and A6.

[7] HKSA 220, paragraphs 12-13.

Planning Activities

The Overall Audit Strategy (Ref: Para. 7-8)

A8. The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;

- The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

- When these resources are to be deployed, such as whether at an interim audit stage or at key cutoff dates; and

- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

A9. The Appendix lists examples of considerations in establishing the overall audit strategy.

A10. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The establishment of the overall audit strategy and the detailed audit plan are not necessarily discrete or sequential processes, but are closely inter-related since changes in one may result in consequential changes to the other.

Considerations Specific to Smaller Entities

A11. In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the engagement partner (who may be a sole practitioner) working with one engagement team member (or without any engagement team members). With a smaller team, co-ordination of, and communication between, team members are easier. Establishing the overall audit strategy for the audit of a small entity need not be a complex or time-consuming exercise; it varies according to the size of the entity, the complexity of the audit, and the size of the engagement team. For example, a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated in the current period based on discussions with the owner-manager, can serve as the documented audit strategy for the current audit engagement if it covers the matters noted in paragraph 8.

The Audit Plan (Ref: Para. 9)

A12. The audit plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members. Planning for these audit procedures takes place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures occurs early in the audit process. However, planning the nature, timing and extent of specific further audit procedures depends on the outcome of those risk assessment

Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of materiality in accordance with HKSA 320,[1] and, where applicable:
    - The determination of materiality for components and communication thereof to component auditors in accordance with HKSA 600.[2]
    - The preliminary identification of significant components and material classes of transactions, account balances and disclosures.
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.

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[1] HKSA 320, “Materiality in Planning and Performing an Audit”.

[2] HKSA 600, “Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)”, paragraphs 21-23 and 40(c).

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Hong Kong Standard on Auditing 315

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

Hong Kong Institute of
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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. A88-A94)

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. A95-A97)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over 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. A98-A100)

23. If the entity has an internal audit function,[1] the auditor shall obtain an understanding of the following in order to determine whether the internal audit function is likely to be relevant to the audit:

    (a) The nature of the internal audit function's responsibilities and how the internal audit function fits in the entity's organizational structure; and

    (b) The activities performed, or to be performed, by the internal audit function. (Ref: Para. A101-A103)

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. A104)

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. A105-A108)

    (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref : Para. A109-A113)

    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. A114-A115)

[1] The term "internal audit function" is defined in HKSA 610, "Using the Work of Internal Auditors," paragraph 7(a), as: "An appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control."

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. A130)

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;

    (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. A131-A134)

Conformity and Compliance with International Standards on Auditing

33. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 315, "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.

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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]

[2] HKSA 230, "Audit Documentation," paragraphs 8-11, and A6.

[3] HKSA 320, "Materiality in Planning and Performing an Audit."

- 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.

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.

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

- 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.[5]

A15. 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

A16. 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.

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

A17. 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.

[5] HKSA 240, paragraph 15.

A18. 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.[6]

Regulatory Factors

A19. 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.

A20. 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.[7]

Considerations specific to public sector entities

A21. 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

A22. 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))

A23. 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.

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6 HKSA 220, "Quality Control for an Audit of Financial Statements," paragraph 14.

7 HKSA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements," paragraph 12.

    - ○ 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).

A25. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A26. 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.[9]

A27. 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))

A28. 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.

[9] HKSA 550, paragraph A7.

- 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))

A29. 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.

A30. 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.

A31. 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.

A32. 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).

- 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.

A39. 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.

A40. 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

A41. 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)

A42. 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.

A43. 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

A44. 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

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

A72. 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.

A73. 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.

A74. 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.[11]

A75. 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.

Considerations Specific to Smaller Entities

A76. 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.

[11] HKSA 330, paragraphs A2-A3.

A77. 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.

A78. 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)

A79. 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)

A80. 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)

A81. 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.

balances and transactions, lessening or removing the need for more detailed control activities.

A94. 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)

A95. 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.

A96. 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 A56 above.

A97. 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)

A98. 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.

A99. 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

A100. 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.

Internal Audit Functions (Ref: Para. 23)

A101. The entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed. If the auditor determines that the internal audit function is likely to be relevant to the audit, HKSA 610 applies.

A102. The objectives of an internal audit function, and therefore the nature of its responsibilities and its status within the organization, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. The responsibilities of an internal audit function may include, for example, monitoring of internal control, risk management, and review of compliance with laws and regulations. On the other hand, the responsibilities of the internal audit function may be limited to the review of the economy, efficiency and effectiveness of operations, for example, and accordingly, may not relate to the entity's financial reporting.

A103. If the nature of the internal audit function's responsibilities are related to the entity's financial reporting, the external auditor's consideration of the activities performed, or to be performed, by the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.

Sources of Information (Ref: Para. 24)

A104. 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))

A105. 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.

A106. 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.

A107. 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.

A108. HKSA 705[12] 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))

A109. 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

A110. 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.

A111. 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.

[12] HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report."

(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.

(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.

A112. 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

A113. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A111, 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))

A114. 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.

Appendix 1

(Ref: 4(c), 14-24, A69-A104)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14-24 and A69-A104, 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.

- *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.

Appendix 2

(Ref: Para. A33, A115)

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.

HKSA 320
Issued June 2009; revised July 2010

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

Hong Kong Standard on Auditing 320

Materiality in Planning and Performing an Audit

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reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)

13. If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.

Documentation

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination: [4]

    (a) Materiality for the financial statements as a whole (see paragraph 10);

    (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10);

    (c) Performance materiality (see paragraph 11); and

    (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

Conformity and Compliance with International Standards on Auditing

15. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 320, “Materiality in Planning and Performing an Audit”. Compliance with the requirements of this HKSA ensures compliance with ISA 320.

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[4] HKSA 230, “Audit Documentation,” paragraphs 8-11, and A6.

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

Hong Kong Standard on Auditing 330

The Auditor's Responses to Assessed Risks

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Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with HKSA 315[1] in an audit of financial statements.

Effective Date

2. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Definitions

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

   (a) Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

      (i) Tests of details (of classes of transactions, account balances, and disclosures); and

      (ii) Substantive analytical procedures.

   (b) Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Requirements

Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

6. The auditor shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)

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[1] HKSA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment."

7. In designing the further audit procedures to be performed, the auditor shall:

   (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

      (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and

      (ii) Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9-A18)

   (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

Tests of Controls

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

   (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or

   (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20-A24)

9. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)

Nature and Extent of Tests of Controls

10. In designing and performing tests of controls, the auditor shall:

   (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including:

      (i) How the controls were applied at relevant times during the period under audit;

      (ii) The consistency with which they were applied; and

      (iii) By whom or by what means they were applied. (Ref: Para. A26-A29)

   (b) Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30-A31)

Timing of Tests of Controls

11. The auditor shall test controls for the particular time, or throughout the period, for which the auditor intends to rely on those controls, subject to paragraphs 12 and 15 below, in order to provide an appropriate basis for the auditor's intended reliance. (Ref: Para. A32)

Using audit evidence obtained during an interim period

12. If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall:

    (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and

    (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33-A34)

Using audit evidence obtained in previous audits

13. In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following:

    (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process;

    (b) The risks arising from the characteristics of the control, including whether it is manual or automated;

    (c) The effectiveness of general IT controls;

    (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control;

    (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and

    (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)

14. If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and:

    (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (Ref: Para. A36)

Timing of Substantive Procedures

22. If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing:

    (a) substantive procedures, combined with tests of controls for the intervening period; or

    (b) if the auditor determines that it is sufficient, further substantive procedures only

    that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54-A57)

23. If misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified. (Ref: Para. A58)

Adequacy of Presentation and Disclosure

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A59)

Evaluating the Sufficiency and Appropriateness of Audit Evidence

25. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60-A61)

26. The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)

27. If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

Documentation

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

    (a) The overall responses to address the assessed risks of material misstatement at the financial statement level, and the nature, timing and extent of the further audit procedures performed;

    (b) The linkage of those procedures with the assessed risks at the assertion level; and

    (c) The results of the audit procedures, including the conclusions where these are not otherwise clear. (Ref: Para. A63)

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[2] HKSA 230, "Audit Documentation," paragraphs 8-11, and A6.

29. If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in previous audits, the auditor shall include in the audit documentation the conclusions reached about relying on such controls that were tested in a previous audit.

30. The auditor's documentation shall demonstrate that the financial statements agree or reconcile with the underlying accounting records.

Conformity and Compliance with International Standards on Auditing

31. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 330, "The Auditor's Responses To Assessed Risks". Compliance with the requirements of this HKSA ensures compliance with ISA 330.

* * *

Application and Other Explanatory Material

Overall Responses (Ref: Para. 5)

A1. Overall responses to address the assessed risks of material misstatement at the financial statement level may include:

- Emphasizing to the audit team the need to maintain professional skepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of at an interim date; or modifying the nature of audit procedures to obtain more persuasive audit evidence.

A2. The assessment of the risks of material misstatement at the financial statement level, and thereby the auditor's overall responses, is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to conduct some audit procedures at an interim date rather than at the period end. Deficiencies in the control environment, however, have the opposite effect; for example, the auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

A3. Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach).

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

The Nature, Timing and Extent of Further Audit Procedures (Ref: Para. 6)

A4. The auditor's assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. For example, the auditor may determine that:

(a) Only by performing tests of controls may the auditor achieve an effective response to the assessed risk of material misstatement for a particular assertion;

(b) Performing only substantive procedures is appropriate for particular assertions and, therefore, the auditor excludes the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing controls would be inefficient and therefore the auditor does not intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures; or

(c) A combined approach using both tests of controls and substantive procedures is an effective approach.

However, as required by paragraph 18, irrespective of the approach selected, the auditor designs and performs substantive procedures for each material class of transactions, account balance, and disclosure.

A5. The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedure). The nature of the audit procedures is of most importance in responding to the assessed risks.

A6. Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.

A7. Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

Nature

A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

HKSA 530[4] contains further guidance on the extent of testing.

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls;
- The authorized version of the program is used for processing transactions; and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as "indirect" controls.

4 HKSA 530, "Audit Sampling."

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

(a) have not changed since they were last tested; and

(b) are not controls that mitigate a significant risk,

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.
- Deficient monitoring of controls.
- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para. 16-17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

Substantive Procedures (Ref: Para. 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This requirement reflects the facts that: (a) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to internal control, including management override.

Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. HKSA 520[5] establishes requirements and provides guidance on the application of analytical procedures during an audit.

A45. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

A46. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See HKSA 500. [6]

Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cutoff assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

5 HKSA 520, "Analytical Procedures."

6 HKSA 500, "Audit Evidence," paragraph 10.

- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.
- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:

  (a) Significant unusual transactions or entries (including those at or near the period end);

  (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and

  (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

Adequacy of Presentation and Disclosure (Ref: Para. 24)

A59. Evaluating the overall presentation of the financial statements, including the related disclosures, relates to whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information, and the form, arrangement, and content of the financial statements and their appended notes. This includes, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 25-27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

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Hong Kong Standard on Auditing 402

Audit Considerations Relating to an Entity Using a Service Organization

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Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organization

18. If the user auditor plans to use a type 1 or a type 2 report that excludes the services provided by a subservice organization and those services are relevant to the audit of the user entity's financial statements, the user auditor shall apply the requirements of this HKSA with respect to the services provided by the subservice organization. (Ref: Para. A40)

Fraud, Non-Compliance with Laws and Regulations, and Uncorrected Misstatements in Relation to Activities at the Service Organization

19. The user auditor shall inquire of management of the user entity whether the service organization has reported to the user entity, or whether the user entity is otherwise aware of, any fraud, non-compliance with laws and regulations or uncorrected misstatements affecting the financial statements of the user entity. The user auditor shall evaluate how such matters affect the nature, timing and extent of the user auditor's further audit procedures, including the effect on the user auditor's conclusions and user auditor's report. (Ref: Para. A41)

Reporting by the User Auditor

20. The user auditor shall modify the opinion in the user auditor's report in accordance with HKSA 705[5] if the user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements. (Ref: Para. A42)

21. The user auditor shall not refer to the work of a service auditor in the user auditor's report containing an unmodified opinion unless required by law or regulation to do so. If such reference is required by law or regulation, the user auditor's report shall indicate that the reference does not diminish the user auditor's responsibility for the audit opinion. (Ref: Para. A43)

22. If reference to the work of a service auditor is relevant to an understanding of a modification to the user auditor's opinion, the user auditor's report shall indicate that such reference does not diminish the user auditor's responsibility for that opinion. (Ref: Para. A44)

Conformity and Compliance with International Standards on Auditing

23. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 402 "Audit Considerations Relating to an Entity Using a Service Organization". Compliance with the requirements of this HKSA ensures compliance with ISA 402.

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Application and Other Explanatory Material

Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control

Sources of Information (Ref: Para. 9)

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.

[5] HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report," paragraph 6.

- System overviews.
- Technical manuals.
- The contract or service level agreement between the user entity and the service organization.
- Reports by service organizations, internal auditors or regulatory authorities on controls at the service organization.
- Reports by the service auditor, including management letters, if available.

A2. Knowledge obtained through the user auditor's experience with the service organization, for example, through experience with other audit engagements, may also be helpful in obtaining an understanding of the nature of the services provided by the service organization. This may be particularly helpful if the services and controls at the service organization over those services are highly standardized.

Nature of the Services Provided by the Service Organization (Ref: Para. 9(a))

A3. A user entity may use a service organization such as one that processes transactions and maintains related accountability, or records transactions and processes related data. Service organizations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others; mortgage bankers that service mortgages for others; and application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operational transactions.

A4. Examples of service organization services that are relevant to the audit include:

- Maintenance of the user entity's accounting records.
- Management of assets.
- Initiating, recording or processing transactions as agent of the user entity.

Considerations Specific to Smaller Entities

A5. Smaller entities may use external bookkeeping services ranging from the processing of certain transactions (for example, payment of payroll taxes) and maintenance of their accounting records to the preparation of their financial statements. The use of such a service organization for the preparation of its financial statements does not relieve management of the smaller entity and, where appropriate, those charged with governance of their responsibilities for the financial statements.[6]

Nature and Materiality of Transactions Processed by the Service Organization (Ref: Para. 9(b))

A6. A service organization may establish policies and procedures that affect the user entity's internal control. These policies and procedures are at least in part physically and operationally separate from the user entity. The significance of the controls of the service organization to those of the user entity depends on the nature of the services provided by the service organization, including the nature and materiality of the transactions it processes for the user entity. In certain situations, the transactions processed and the accounts affected by the

[6] HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraphs 4 and A2-A3.

(b) Substantive procedures on the user entity's financial statement transactions and balances maintained by a service organization.

Considerations Specific to Public Sector Entities

A10. Public sector auditors generally have broad rights of access established by legislation. However, there may be situations where such rights of access are not available, for example, when the service organization is located in a different jurisdiction. In such cases, a public sector auditor may need to obtain an understanding of the legislation applicable in the different jurisdiction to determine whether appropriate access rights can be obtained. A public sector auditor may also obtain or ask the user entity to incorporate rights of access in any contractual arrangements between the user entity and the service organization.

A11. Public sector auditors may also use another auditor to perform tests of controls or substantive procedures in relation to compliance with law, regulation or other authority.

Understanding the Controls Relating to Services Provided by the Service Organization (Ref: Para. 10)

A12. The user entity may establish controls over the service organization's services that may be tested by the user auditor and that may enable the user auditor to conclude that the user entity's controls are operating effectively for some or all of the related assertions, regardless of the controls in place at the service organization. If a user entity, for example, uses a service organization to process its payroll transactions, the user entity may establish controls over the submission and receipt of payroll information that could prevent or detect material misstatements. These controls may include:

- Comparing the data submitted to the service organization with reports of information received from the service organization after the data has been processed.
- Recomputing a sample of the payroll amounts for clerical accuracy and reviewing the total amount of the payroll for reasonableness.

A13. In this situation, the user auditor may perform tests of the user entity's controls over payroll processing that would provide a basis for the user auditor to conclude that the user entity's controls are operating effectively for the assertions related to payroll transactions.

A14. As noted in HKSA 315,[7] in respect of some risks, the user 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 and account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. Such automated processing characteristics may be particularly present when the user entity uses service organizations. In such cases, the user entity's controls over such risks are relevant to the audit and the user auditor is required to obtain an understanding of, and to evaluate, such controls in accordance with paragraphs 9 and 10 of this HKSA.

Further Procedures When a Sufficient Understanding Cannot Be Obtained from the User Entity (Ref: Para. 12)

A15. The user auditor's decision as to which procedure, individually or in combination, in paragraph 12 to undertake, in order to obtain the information necessary to provide a basis for the identification and assessment of the risks of material misstatement in relation to the user entity's use of the service organization, may be influenced by such matters as:

[7] HKSA 315, paragraph 30.

- The size of both the user entity and the service organization;
- The complexity of the transactions at the user entity and the complexity of the services provided by the service organization;
- The location of the service organization (for example, the user auditor may decide to use another auditor to perform procedures at the service organization on the user auditor's behalf if the service organization is in a remote location);
- Whether the procedure(s) is expected to effectively provide the user auditor with sufficient appropriate audit evidence; and
- The nature of the relationship between the user entity and the service organization.

A16. A service organization may engage a service auditor to report on the description and design of its controls (type 1 report) or on the description and design of its controls and their operating effectiveness (type 2 report). Type 1 or type 2 reports may be issued under Hong Kong Standard on Assurance Engagements (HKSAE) 3402 [8] or under standards established by an authorized or recognized standards setting organization (which may identify them by different names, such as Type A or Type B reports).

A17. The availability of a type 1 or type 2 report will generally depend on whether the contract between a service organization and a user entity includes the provision of such a report by the service organization. A service organization may also elect, for practical reasons, to make a type 1 or type 2 report available to the user entities. However, in some cases, a type 1 or type 2 report may not be available to user entities.

A18. In some circumstances, a user entity may outsource one or more significant business units or functions, such as its entire tax planning and compliance functions, or finance and accounting or the controllership function to one or more service organizations. As a report on controls at the service organization may not be available in these circumstances, visiting the service organization may be the most effective procedure for the user auditor to gain an understanding of controls at the service organization, as there is likely to be direct interaction of management of the user entity with management at the service organization.

A19. Another auditor may be used to perform procedures that will provide the necessary information about the relevant controls at the service organization. If a type 1 or type 2 report has been issued, the user auditor may use the service auditor to perform these procedures as the service auditor has an existing relationship with the service organization. The user auditor using the work of another auditor may find the guidance in HKSA 600 [9] useful as it relates to understanding another auditor (including that auditor's independence and professional competence), involvement in the work of another auditor in planning the nature, timing and extent of such work, and in evaluating the sufficiency and appropriateness of the audit evidence obtained.

A20. A user entity may use a service organization that in turn uses a subservice organization to provide some of the services provided to a user entity that are part of the user entity's information system relevant to financial reporting. The subservice organization may be a separate entity from the service organization or may be related to the service organization. A user auditor may need to consider controls at the subservice organization. In situations where one or more subservice organizations are used, the interaction between the activities of the user

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8 HKSAE 3402, "Assurance Reports on Controls at a Service Organization."

9 HKSA 600, "Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors), paragraph 2, states: "An auditor may find this HKSA, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements …" See also paragraph 19 of HKSA 600.

- Instances where complementary user entity controls are noted in the type 1 or type 2 report and are not implemented at the user entity; and
- Controls that may be needed at the service organization that do not appear to have been implemented or that are not specifically covered by a type 2 report.

Type 1 and Type 2 Reports that Exclude the Services of a Subservice Organization (Ref: Para. 18)

A40. If a service organization uses a subservice organization, the service auditor's report may either include or exclude the subservice organization's relevant control objectives and related controls in the service organization's description of its system and in the scope of the service auditor's engagement. These two methods of reporting are known as the inclusive method and the carve-out method, respectively. If the type 1 or type 2 report excludes the controls at a subservice organization, and the services provided by the subservice organization are relevant to the audit of the user entity's financial statements, the user auditor is required to apply the requirements of this HKSA in respect of the subservice organization. The nature and extent of work to be performed by the user auditor regarding the services provided by a subservice organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The application of the requirement in paragraph 9 assists the user auditor in determining the effect of the subservice organization and the nature and extent of work to be performed.

Fraud, Non-Compliance with Laws and Regulations, and Uncorrected Misstatements in Relation to Activities at the Service Organization (Ref: Para. 19)

A41. A service organization may be required under the terms of the contract with user entities to disclose to affected user entities any fraud, non-compliance with laws and regulations or uncorrected misstatements attributable to the service organization's management or employees. As required by paragraph 19, the user auditor makes inquiries of the user entity management regarding whether the service organization has reported any such matters and evaluates whether any matters reported by the service organization affect the nature, timing and extent of the user auditor's further audit procedures. In certain circumstances, the user auditor may require additional information to perform this evaluation, and may request the user entity to contact the service organization to obtain the necessary information.

Reporting by the User Auditor (Ref: Para. 20)

A42. When a user auditor is unable to obtain sufficient appropriate audit evidence regarding the services provided by the service organization relevant to the audit of the user entity's financial statements, a limitation on the scope of the audit exists. This may be the case when:

- The user auditor is unable to obtain a sufficient understanding of the services provided by the service organization and does not have a basis for the identification and assessment of the risks of material misstatement;
- A user auditor's risk assessment includes an expectation that controls at the service organization are operating effectively and the user auditor is unable to obtain sufficient appropriate audit evidence about the operating effectiveness of these controls; or
- Sufficient appropriate audit evidence is only available from records held at the service organization, and the user auditor is unable to obtain direct access to these records.

Whether the user auditor expresses a qualified opinion or disclaims an opinion depends on the user auditor's conclusion as to whether the possible effects on the financial statements are material or pervasive.

HKSA 450
Issued July 2009; revised July 2010

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

Hong Kong Standard on Auditing 450

Evaluation of Misstatements Identified during the Audit

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HONG KONG STANDARD ON AUDITING 450

EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

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

CONTENTS

Hong Kong Standard on Auditing (HKSA) 450, “Evaluation of Misstatements Identified during the Audit” should be read in the context of HKSA 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing.”

Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.[4] The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representations

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)

Documentation

15. The auditor shall include in the audit documentation: [5] (Ref: Para. A25)

    (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);

    (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and

    (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

Conformity and Compliance with International Standards on Auditing

16. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 450, "Evaluation of Misstatements Identified during the Audit". Compliance with the requirements of this HKSA ensures compliance with ISA 450.

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Application and Other Explanatory Material

Definition of Misstatement (Ref: Para. 4(a))

A1. Misstatements may result from:

    (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;

    (b) An omission of an amount or disclosure;

[4] See footnote 3.

[5] HKSA 230, "Audit Documentation," paragraphs 8-11, and A6.

responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.[14]

A22. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A23. HKSA 260 requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this HKSA).[15] The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

Written Representations (Ref: Para. 14)

A24. Because the preparation of the financial statements requires management and, where appropriate, those charged with governance to adjust the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: “We do not agree that items … and … constitute misstatements because [description of reasons].” Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

A25. The auditor’s documentation of uncorrected misstatements may take into account:

(a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

[14] HKSA 260, paragraph 13.

[15] HKSA 260, paragraph 16(c)(ii).

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Audit Evidence

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(d) Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

(e) Sufficiency (of audit evidence) – The measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence.

Requirements

Sufficient Appropriate Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)

8. If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: (Ref: Para. A34-A36)

   (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)

   (b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)

   (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances:

   (a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)

   (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

Selecting Items for Testing to Obtain Audit Evidence

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

A35. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this HKSA applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this HKSA, but is not the use of a management's expert by the entity.

A36. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this HKSA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities, and Objectivity of a Management's Expert (Ref: Para. 8(a))

A37. Competence relates to the nature and level of expertise of the management's expert. Capability relates the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.

A43. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management's Expert (Ref: Para. 8(b))

A44. An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's expert, or whether the auditor needs an auditor's expert for this purpose.[15]

A45. Aspects of the management's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the management's expert uses.

A46. In the case of a management's expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when obtaining an understanding of the work of the management's expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert; and
- The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A47. In the case of a management's expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

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[15] HKSA 620, "Using the Work of an Auditor's Expert," paragraph 7.

Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;

- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and

- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Information Produced by the Entity and Used for the Auditor's Purposes (Ref: Para. 9(a)-(b))

A49. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorization), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

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. 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.

Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 10)

A52. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);

(b) Selecting specific items; and

(c) Audit sampling.

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Hong Kong Standard on Auditing 501

Audit Evidence — Specific Considerations for Selected Items

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These procedures may serve as test of controls or substantive procedures depending on the auditor's risk assessment, planned approach and the specific procedures carried out.

A3. Matters relevant in planning attendance at physical inventory counting (or in designing and performing audit procedures pursuant to paragraphs 4-8 of this HKSA) include, for example:

- The risks of material misstatement related to inventory.
- The nature of the internal control related to inventory.
- Whether adequate procedures are expected to be established and proper instructions issued for physical inventory counting.
- The timing of physical inventory counting.
- Whether the entity maintains a perpetual inventory system.
- The locations at which inventory is held, including the materiality of the inventory and the risks of material misstatement at different locations, in deciding at which locations attendance is appropriate. HKSA 600[4] deals with the involvement of other auditors and accordingly may be relevant if such involvement is with regard to attendance of physical inventory counting at a remote location.
- Whether the assistance of an auditor's expert is needed. HKSA 620[5] deals with the use of an auditor's expert to assist the auditor to obtain sufficient appropriate audit evidence.

Evaluate Management's Instructions and Procedures (Ref: Para. 4(a)(i))

A4. Matters relevant in evaluating management's instructions and procedures for recording and controlling the physical inventory counting include whether they address, for example:

- The application of appropriate control activities, for example, collection of used physical inventory count records, accounting for unused physical inventory count records, and count and re-count procedures.
- The accurate identification of the stage of completion of work in progress, of slow moving, obsolete or damaged items and of inventory owned by a third party, for example, on consignment.
- The procedures used to estimate physical quantities, where applicable, such as may be needed in estimating the physical quantity of a coal pile.
- Control over the movement of inventory between areas and the shipping and receipt of inventory before and after the cutoff date.

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

5 HKSA 620, "Using the Work of an Auditor's Expert."

Observe the Performance of Management's Count Procedures (Ref: Para. 4(a)(ii))

A5. Observing the performance of management's count procedures, for example, those relating to control over the movement of inventory before, during and after the count, assists the auditor in obtaining audit evidence that management's instructions and count procedures are adequately designed and implemented. In addition, the auditor may obtain copies of cutoff information, such as details of the movement of inventory, to assist the auditor in performing audit procedures over the accounting for such movements at a later date.

Inspect the Inventory (Ref: Para. 4(a)(iii))

A6. Inspecting inventory when attending physical inventory counting assists the auditor in ascertaining the existence of the inventory (though not necessarily its ownership), and in identifying, for example, obsolete, damaged or aging inventory.

Perform Test Counts (Ref: Para. 4(a)(iv))

A7. Performing test counts, for example, by tracing items selected from management's count records to the physical inventory and tracing items selected from the physical inventory to management's count records, provides audit evidence about the completeness and the accuracy of those records.

A8. In addition to recording the auditor's test counts, obtaining copies of management's completed physical inventory count records assists the auditor in performing subsequent audit procedures to determine whether the entity's final inventory records accurately reflect actual inventory count results.

Physical Inventory Counting Conducted Other than At the Date of the Financial Statements (Ref: Para. 5)

A9. For practical reasons, the physical inventory counting may be conducted at a date, or dates, other than the date of the financial statements. This may be done irrespective of whether management determines inventory quantities by an annual physical inventory counting or maintains a perpetual inventory system. In either case, the effectiveness of the design, implementation and maintenance of controls over changes in inventory determines whether the conduct of physical inventory counting at a date, or dates, other than the date of the financial statements is appropriate for audit purposes. HKSA 330 establishes requirements and provides guidance on substantive procedures performed at an interim date.[6]

A10. Where a perpetual inventory system is maintained, management may perform physical counts or other tests to ascertain the reliability of inventory quantity information included in the entity's perpetual inventory records. In some cases, management or the auditor may identify differences between the perpetual inventory records and actual physical inventory quantities on hand; this may indicate that the controls over changes in inventory are not operating effectively.

A11. Relevant matters for consideration when designing audit procedures to obtain audit evidence about whether changes in inventory amounts between the count date, or dates, and the final inventory records are properly recorded include:

- Whether the perpetual inventory records are properly adjusted.
- Reliability of the entity's perpetual inventory records.

[6] HKSA 330, paragraphs 22-23.

- Reasons for significant differences between the information obtained during the physical count and the perpetual inventory records.

Attendance at Physical Inventory Counting Is Impracticable (Ref: Para. 7)

A12. In some cases, attendance at physical inventory counting may be impracticable. This may be due to factors such as the nature and location of the inventory, for example, where inventory is held in a location that may pose threats to the safety of the auditor. The matter of general inconvenience to the auditor, however, is not sufficient to support a decision by the auditor that attendance is impracticable. Further, as explained in HKSA 200,[7] the matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive.

A13. In some cases where attendance is impracticable, alternative audit procedures, for example, inspection of documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory counting, may provide sufficient appropriate audit evidence about the existence and condition of inventory.

A14. In other cases, however, it may not be possible to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by performing alternative audit procedures. In such cases, HKSA 705 requires the auditor to modify the opinion in the auditor's report as a result of the scope limitation.[8]

Inventory under the Custody and Control of a Third Party

Confirmation (Ref: Para. 8(a))

A15. HKSA 505[9] establishes requirements and provides guidance for performing external confirmation procedures.

Other Audit Procedures (Ref: Para. 8(b))

A16. Depending on the circumstances, for example, where information is obtained that raises doubt about the integrity and objectivity of the third party, the auditor may consider it appropriate to perform other audit procedures instead of, or in addition to, confirmation with the third party. Examples of other audit procedures include:

- Attending, or arranging for another auditor to attend, the third party's physical counting of inventory, if practicable.

- Obtaining another auditor's report, or a service auditor's report, on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded.

- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts.

- Requesting confirmation from other parties when inventory has been pledged as collateral.

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7 HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraph A48.

8 HKSA 705, paragraph 13.

9 HKSA 505, "External Confirmations."

Litigation and Claims

Completeness of Litigations and Claims (Ref: Para. 9)

A17. Litigation and claims involving the entity may have a material effect on the financial statements and thus may be required to be disclosed or accounted for in the financial statements.

A18. In addition to the procedures identified in paragraph 9, other relevant procedures include, for example, using information obtained through risk assessment procedures carried out as part of obtaining an understanding of the entity and its environment to assist the auditor to become aware of litigation and claims involving the entity.

A19. Audit evidence obtained for purposes of identifying litigation and claims that may give rise to a risk of material misstatement also may provide audit evidence regarding other relevant considerations, such as valuation or measurement, regarding litigation and claims. HKSA 540 [10] establishes requirements and provides guidance relevant to the auditor's consideration of litigation and claims requiring accounting estimates or related disclosures in the financial statements.

Reviewing Legal Expense Accounts (Ref: Para. 9(c))

A20. Depending on the circumstances, the auditor may judge it appropriate to examine related source documents, such as invoices for legal expenses, as part of the auditor's review of legal expense accounts.

Communication with the Entity's External Legal Counsel [10a] (Ref: Para. 10-11)

A21. Direct communication with the entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reasonable.

A22. In some cases, the auditor may seek direct communication with the entity's external legal counsel through a letter of general inquiry. For this purpose, a letter of general inquiry requests the entity's external legal counsel to inform the auditor of any litigation and claims that the counsel is aware of, together with an assessment of the outcome of the litigation and claims, and an estimate of the financial implications, including costs involved.

A23. If it is considered unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry, for example, if the professional body to which the external legal counsel belongs prohibits response to such a letter, the auditor may seek direct communication through a letter of specific inquiry. For this purpose, a letter of specific inquiry includes:

(a) A list of litigation and claims;

(b) Where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and

(c) A request that the entity's external legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's external legal counsel to be incomplete or incorrect.

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[10] HKSA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures."

[10a] For the purpose of this section, "external legal counsel" may include solicitor, barrister or overseas professional legal advisor.

A23-1. The following form of wording, appropriate to specific enquiries, has been agreed with the Council of the Law Society of Hong Kong as one which may be properly addressed to and answered by external legal counsel:

"In connection with the preparation and audit of our accounts for the year ended ...... the directors have made estimates of the amounts of the ultimate liabilities (including costs) which might be incurred, and are regarded as material, in relation to the following matters on which you have been consulted. We should be obliged if you would confirm that in your opinion these estimates are reasonable.

Matter Estimated liability including costs"

A23-2. The Council of the Hong Kong Institute of Certified Public Accountants understands the reasons for the view[*] of the Council of the Law Society of Hong Kong regarding non-specific enquiries, but nevertheless believes that there may be circumstances in which it is necessary as an audit procedure for an enquiry of a general nature to be addressed to the external legal counsel in order to confirm that the information provided by the directors is complete in all material particulars.

A23-3. It may be necessary for auditor to make reference to local requirements if he is making enquiries of overseas external legal counsel as different form of wording for the enquiry letter to external legal counsel might have been agreed between the local professional accountants and legal counsel associations.

A24. In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case, for example, where:

- The auditor determines that the matter is a significant risk.
- The matter is complex.
- There is disagreement between management and the entity's external legal counsel.

Ordinarily, such meetings require management's permission and are held with a representative of management in attendance.

A25. In accordance with HKSA 700,[11] the auditor is required to date the auditor's report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. Audit evidence about the status of litigation and claims up to the date of the auditor's report may be obtained by inquiry of management, including in-house legal counsel, responsible for dealing with the relevant matters. In some instances, the auditor may need to obtain updated information from the entity's external legal counsel.

Segment Information (Ref: Para. 13)

A26. Depending on the applicable financial reporting framework, the entity may be required or permitted to disclose segment information in the financial statements. The auditor's responsibility regarding the presentation and disclosure of segment information is in relation to the financial statements taken as a whole. Accordingly, the auditor is not required to perform audit procedures that would be necessary to express an opinion on the segment information presented on a standalone basis.

[*] The Council of the Law Society of Hong Kong has advised legal counsel that it is unable to recommend them to comply with non-specific requests for information.

[11] HKSA 700, "Forming an Opinion and Reporting on Financial Statements," paragraph 41.

HKSA 510
Issued September 2009; revised July 2010

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

Hong Kong Standard on Auditing 510

Initial Audit Engagements —Opening Balances

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

Audit Conclusions and Reporting

Opening Balances

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with HKSA 705.[5] (Ref: Para. A8)

11. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with HKSA 705.

Consistency of Accounting Policies

12. If the auditor concludes that:

    (a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or

    (b) a change in accounting policies is not appropriately accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

    the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with HKSA 705.

Modification to the Opinion in the Predecessor Auditor's Report

13. If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with HKSA 705 and HKSA 710. (Ref: Para. A9)

Conformity and Compliance with International Standards on Auditing

14. As of September 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 510, "Initial Audit Engagements—Opening Balances". Compliance with the requirements of this HKSA ensures compliance with ISA 510.

15. Additional local explanation and guidance is provided in footnote 5a and Appendix.

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Application and Other Explanatory Material

Audit Procedures

Considerations Specific to Public Sector Entities (Ref: Para. 6)

A1. In the public sector, there may be legal or regulatory limitations on the information that the current auditor can obtain from a predecessor auditor. For example, if a public sector entity that has previously been audited by a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General) is

5 HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report."

privatized, the amount of access to working papers or other information that the statutorily appointed auditor can provide a newly-appointed auditor that is in the private sector may be constrained by privacy or secrecy laws or regulations. In situations where such communications are constrained, audit evidence may need to be obtained through other means and, if sufficient appropriate audit evidence cannot be obtained, consideration given to the effect on the auditor's opinion.

A2. If the statutorily appointed auditor outsources an audit of a public sector entity to a private sector audit firm, and the statutorily appointed auditor appoints an audit firm other than the firm that audited the financial statements of the public sector entity in the prior period, this is not usually regarded as a change in auditors for the statutorily appointed auditor. Depending on the nature of the outsourcing arrangement, however, the audit engagement may be considered an initial audit engagement from the perspective of the private sector auditor in fulfilling the auditor's responsibilities, and therefore this HKSA applies.

Opening Balances (Ref: Para. 6(c))

A3. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

A4. If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by reviewing the predecessor auditor's working papers. Whether such a review provides sufficient appropriate audit evidence is influenced by the professional competence and independence of the predecessor auditor.

A5. Relevant ethical and professional requirements guide the current auditor's communications with the predecessor auditor.

A6. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cutoff.

A7. For non-current assets and liabilities, such as property, plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

Opening Balances (Ref: Para. 10)

A8. HKSA 705 establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

(a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or

(b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations, and cash flows, where relevant, and unmodified regarding financial position.[5a]

The Appendix includes illustrative auditors' reports.

Modification to the Opinion in the Predecessor Auditor's Report (Ref: Para. 13)

A9. In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

[5a] This form of opinion is permitted in Hong Kong.

Appendix

(Ref: Para. A8)

Illustrations of Auditors' Reports with Modified Opinions

<u>Illustration 1</u>:

Circumstances described in paragraph A8(a) include the following:

- **The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.**
- **The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's financial performance and cash flows.**[1]
- **The financial position at year end is fairly presented.**
- **In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the financial performance and cash flows and unmodified regarding financial position.[1a]**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [country or place] with limited liability)[1b]

[Report on the Financial Statements][2]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][2a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][2a], statement of changes in equity and [cash flow statement][statement of cash flows][2a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' [3] *Responsibility for the Financial Statements*

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants [and the disclosure requirements of the Hong Kong Companies Ordinance[4a]], and for such internal control as the directors determine is necessary to enable the

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[1] If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's financial performance and cash flows, the auditor would disclaim an opinion on the financial performance and cash flows.

[1a] This form of opinion is permitted in Hong Kong.

[1b] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[2] The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[2a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[3] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

[4] Not used.

[4a] For a company incorporated overseas and listed in Hong Kong, the disclosure requirements of the Hong Kong Companies Ordinance are applicable.

preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[4b]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[6] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

We were appointed as auditors of the Company on 30 June 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 31 December 20X0. Since opening inventories enter into the determination of the [profit][loss] and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the [profit][loss] for the year reported in the [income statement][statement of comprehensive income][2a] and the net cash flows from operating activities reported in the [cash flow statement][statement of cash flows].[2a]

Qualified Opinion

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

Other Matter

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

4b Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

5 Not used.

6 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[2]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

Illustration 2:

Circumstances described in paragraph A8(b) include the following:

- **The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.**
- **The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's financial performance and cash flows.**[7]
- **The financial position at year end is fairly presented.**
- **An opinion that is qualified regarding the financial performance and cash flows and unmodified regarding financial position is considered appropriate in the circumstances.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[7a]

Report on the Financial Statements

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][8a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][8a], statement of changes in equity and [cash flow statement][statement of cash flows][8a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' [9] *Responsibility for the Financial Statements*

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

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7 If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's financial performance and cash flows, the auditor would disclaim the opinion on the financial performance and cash flows.

7a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

8 Not used.

8a Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

9 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

10 Not used.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[10a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[12] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the financial position and our qualified audit opinion on the financial performance and cash flows.

Basis for Qualified Opinion on the [Profit][Loss] and Cash Flows

We were appointed as auditors of the Company on 30 June 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 31 December 20X0. Since opening inventories enter into the determination of the [profit][loss] and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the [profit][loss] for the year reported in the [income statement][statement of comprehensive income][8a] and the net cash flows from operating activities reported in the [cash flow statement][statement of cash flows].[8a]

Qualified Opinion on the [Profit][Loss] and Cash Flows

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the [income statement][statement of comprehensive income][13a] and [cash flow statement][statement of cash flows][13a] give a true and fair view of the Company's [profit][loss] and cash flows for the year ended 31 December 20X1 in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

Opinion on the Financial Position

In our opinion, the [balance sheet][statement of financial position][8a] gives a true and fair view of the state of the Company's affairs as at 31 December 20X1 in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the Hong Kong Companies Ordinance.

10a Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

11 Not used.

12 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

HKSA 530
Issued July 2009; revised July 2010

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

Hong Kong Standard on Auditing 530

Audit Sampling

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

(d) Non-sampling risk – The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para. A1)

(e) Anomaly – A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

(f) Sampling unit – The individual items constituting a population. (Ref: Para. A2)

(g) Statistical sampling – An approach to sampling that has the following characteristics:

(i) Random selection of the sample items; and

(ii) The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling.

(h) Stratification – The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).

(i) Tolerable misstatement – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (Ref: Para. A3)

(j) Tolerable rate of deviation – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Requirements

Sample Design, Size, and Selection of Items for Testing

6. When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)

7. The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10-A11)

8. The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)

Performing Audit Procedures

9. The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.

10. If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)

11. If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15-A16)

defined in HKSA 320,[2] to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Sample Design, Size, and Selection of Items for Testing

Sample Design (Ref: Para. 6)

A4. Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

A5. When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirement of paragraph 10 of HKSA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

A6. The auditor's consideration of the purpose of the audit procedure, as required by paragraph 6, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only those, conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

A7. In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

A8. In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value-weighted selection is appropriate. Appendix 1 provides further discussion on stratification and value-weighted selection.

A9. The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

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[2] HKSA 320, "Materiality in Planning and Performing an Audit," paragraph 9.

HKSA 540
Issued July 2009; revised July 2010

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

Hong Kong Standard on Auditing 540

Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

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

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103-A106)

(b) Whether the significant assumptions used by management are reasonable. (Ref: Para. A107-A109)

(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. (Ref: Para. A110)

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111-A112)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:

(a) Management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and (Ref: Para. A113-A114)

(b) The selected measurement basis for the accounting estimates, (Ref: Para. A115)

are in accordance with the requirements of the applicable financial reporting framework.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116-A119)

Disclosures Related to Accounting Estimates

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122-A123)

Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable. (Ref: Para. A126-A127)

Documentation

23. The auditor shall include in the audit documentation:[8]

    (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and

    (b) Indicators of possible management bias, if any. (Ref: Para. A128)

Conformity and Compliance with International Standards on Auditing

24. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures". Compliance with the requirements of this HKSA ensures compliance with ISA 540.

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Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this HKSA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.

- Accounting estimates that are frequently made and updated because they relate to routine transactions.

- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.

- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.

- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

[8] HKSA 230, "Audit Documentation," paragraphs 8-11, and A6.

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialized entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Costs arising from litigation settlements and judgments.

A7. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
- Property or equipment held for disposal.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by HKSA 240.[12] That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this HKSA may be carried out in conjunction with the review required by HKSA 240.

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognized in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognized in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the preparation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

Identifying and Assessing the Risks of Material Misstatement

Estimation Uncertainty (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.

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12 HKSA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements," paragraph 32(b)(ii).

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Responses to the Assessed Risks of Material Misstatements (Ref: Para. 13)

A59. The auditor's decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

Events Occurring Up to the Date of the Auditor's Report (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and
- Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor's report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realizable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A80. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorizations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above, where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market-specific inputs into the development of assumptions.
- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- 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 market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:

- The identification of the characteristics of marketplace participants relevant to the accounting estimate.
- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.

- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.

- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.

- There are alternative sources of relevant data available to the auditor which can be used in developing a point estimate or a range.

A88. Even where the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to develop a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.

- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.

- Employing or engaging a person with specialized expertise to develop or execute the model, or to provide relevant assumptions.

- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: Para. 13(d)(i))

A92. When the auditor develops a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

(a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and

(b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering Whether Specialized Skills or Knowledge Are Required (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement.[20] This may include, as necessary, the involvement of those with specialized skills or knowledge. In addition, HKSA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement.[21] During the course of the audit of accounting estimates the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialized skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

[20] HKSA 300, "Planning an Audit of Financial Statements," paragraph 8(e).

[21] HKSA 220, "Quality Control for an Audit of Financial Statements," paragraph 14.

Appendix

(Ref: Para. A1)

Fair Value Measurements and Disclosures under Different Financial Reporting Frameworks

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Hong Kong Accounting Standard (HKAS) 39[1] defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity-specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this HKSA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

    - Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;

    - Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;

    - Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;

    - Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or

[1] HKAS 39, "Financial Instruments: Recognition and Measurement."

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Hong Kong Standard on Auditing 550

Related Parties

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5. In addition, an understanding of the entity's related party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by HKSA 240,[4] because fraud may be more easily committed through related parties.

6. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the HKSAs.[5] In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

- Management [5a] may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.

- Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

7. Planning and performing the audit with professional skepticism as required by HKSA 200 [6] is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions. The requirements in this HKSA are designed to assist the auditor in identifying and assessing the risks of material misstatement associated with related party relationships and transactions, and in designing audit procedures to respond to the assessed risks.

Effective Date

8. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Objectives

9. The objectives of the auditor are:

 (a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, to obtain an understanding of related party relationships and transactions sufficient to be able:

  (i) To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and

  (ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions:

   a. Achieve fair presentation (for fair presentation frameworks); or

   b. Are not misleading (for compliance frameworks); and

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[4] HKSA 240, paragraph 24.

[5] HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraphs A51-A52.

[5a] Under the Companies Ordinance, the directors are responsible for the preparation of financial statements showing a true and fair view.

[6] HKSA 200, paragraph 15.

(b) Whether related parties could be involved. (Ref: Para. A27)

Sharing Related Party Information with the Engagement Team

17. The auditor shall share relevant information obtained about the entity's related parties with the other members of the engagement team. (Ref: Para. A28)

Identification and Assessment of the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

18. In meeting the HKSA 315 requirement to identify and assess the risks of material misstatement,[9] the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.

19. If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with HKSA 240. (Ref: Para. A6, A29-A30)

Responses to the Risks of Material Misstatement Associated with Related Party Relationships and Transactions

20. As part of the HKSA 330 requirement that the auditor respond to assessed risks,[10] the auditor designs and performs further audit procedures to obtain sufficient appropriate audit evidence about the assessed risks of material misstatement associated with related party relationships and transactions. These audit procedures shall include those required by paragraphs 21-24. (Ref: Para. A31-A34)

Identification of Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions

21. If the auditor identifies arrangements or information that suggests the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor, the auditor shall determine whether the underlying circumstances confirm the existence of those relationships or transactions.

22. If the auditor identifies related parties or significant related party transactions that management has not previously identified or disclosed to the auditor, the auditor shall:

    (a) Promptly communicate the relevant information to the other members of the engagement team; (Ref: Para. A35)

    (b) Where the applicable financial reporting framework establishes related party requirements:

        (i) Request management to identify all transactions with the newly identified related parties for the auditor's further evaluation; and

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[9] HKSA 315, paragraph 25.

[10] HKSA 330, paragraphs 5-6.

- Records of the entity's investments and those of its pension plans.
- Contracts and agreements with key management or those charged with governance.
- Significant contracts and agreements not in the entity's ordinary course of business.
- Specific invoices and correspondence from the entity's professional advisors.
- Life insurance policies acquired by the entity.
- Significant contracts re-negotiated by the entity during the period.
- Internal auditors' reports.
- Documents associated with the entity's filings with a securities regulator (for example, prospectuses).

Arrangements that may indicate the existence of previously unidentified or undisclosed related party relationships or transactions (Ref: Para. 15)

A23. An arrangement involves a formal or informal agreement between the entity and one or more other parties for such purposes as:

- The establishment of a business relationship through appropriate vehicles or structures.
- The conduct of certain types of transactions under specific terms and conditions.
- The provision of designated services or financial support.

Examples of arrangements that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor include:

- Participation in unincorporated partnerships with other parties.
- Agreements for the provision of services to certain parties under terms and conditions that are outside the entity's normal course of business.
- Guarantees and guarantor relationships.

Identification of Significant Transactions outside the Normal Course of Business (Ref: Para. 16)

A24. Obtaining further information on significant transactions outside the entity's normal course of business enables the auditor to evaluate whether fraud risk factors, if any, are present and, where the applicable financial reporting framework establishes related party requirements, to identify the risks of material misstatement.

A25. Examples of transactions outside the entity's normal course of business may include:

- Complex equity transactions, such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with weak corporate laws.
- The leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.
- Sales transactions with unusually large discounts or returns.

Authorization and Approval of Significant Related Party Transactions (Ref: Para. 23(b))

A40. Authorization and approval by management, those charged with governance, or, where applicable, the shareholders of significant related party transactions outside the entity's normal course of business may provide audit evidence that these have been duly considered at the appropriate levels within the entity and that their terms and conditions have been appropriately reflected in the financial statements. The existence of transactions of this nature that were not subject to such authorization and approval, in the absence of rational explanations based on discussion with management or those charged with governance, may indicate risks of material misstatement due to fraud or error. In these circumstances, the auditor may need to be alert for other transactions of a similar nature. Authorization and approval alone, however, may not be sufficient in concluding whether risks of material misstatement due to fraud are absent because authorization and approval may be ineffective if there has been collusion between the related parties or if the entity is subject to the dominant influence of a related party.

Considerations specific to smaller entities

A41. A smaller entity may not have the same controls provided by different levels of authority and approval that may exist in a larger entity. Accordingly, when auditing a smaller entity, the auditor may rely to a lesser degree on authorization and approval for audit evidence regarding the validity of significant related party transactions outside the entity's normal course of business. Instead, the auditor may consider performing other audit procedures such as inspecting relevant documents, confirming specific aspects of the transactions with relevant parties, or observing the owner-manager's involvement with the transactions.

Assertions That Related Party Transactions Were Conducted on Terms Equivalent to Those Prevailing in an Arm's Length Transaction (Ref: Para. 24)

A42. Although audit evidence may be readily available regarding how the price of a related party transaction compares to that of a similar arm's length transaction, there are ordinarily practical difficulties that limit the auditor's ability to obtain audit evidence that all other aspects of the transaction are equivalent to those of the arm's length transaction. For example, although the auditor may be able to confirm that a related party transaction has been conducted at a market price, it may be impracticable to confirm whether other terms and conditions of the transaction (such as credit terms, contingencies and specific charges) are equivalent to those that would ordinarily be agreed between independent parties. Accordingly, there may be a risk that management's assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated.

A43. The preparation of the financial statements requires management to substantiate an assertion that a related party transaction was conducted on terms equivalent to those prevailing in an arm's length transaction. Management's support for the assertion may include:

- Comparing the terms of the related party transaction to those of an identical or similar transaction with one or more unrelated parties.
- Engaging an external expert to determine a market value and to confirm market terms and conditions for the transaction.
- Comparing the terms of the transaction to known market terms for broadly similar transactions on an open market.

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for periods beginning on or after 15 December 2009

Hong Kong Standard on Auditing 560

Subsequent Events

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(b) Date of approval of the financial statements – The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements. (Ref: Para. A2)

(c) Date of the auditor's report – The date the auditor dates the report on the financial statements in accordance with HKSA 700. (Ref: Para. A3)

(d) Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third parties. (Ref: Para. A4-A5)

(e) Subsequent events – Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

Requirements

Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

6. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: Para. A6)

7. The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: (Ref: Para. A7-A8)

   (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

   (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. (Ref: Para. A9)

   (c) Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available. (Ref: Para. A10)

   (d) Reading the entity's latest subsequent interim financial statements, if any.

8. If, as a result of the procedures performed as required by paragraphs 6 and 7, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

Written Representations

9. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with HKSA 580 [3] that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements are Issued

10. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: (Ref: Para. A11)

    (a) Discuss the matter with management and, where appropriate, those charged with governance;

    (b) Determine whether the financial statements need amendment and, if so,

    (c) Inquire how management intends to address the matter in the financial statements.

11. If management amends the financial statements, the auditor shall:

    (a) Carry out the audit procedures necessary in the circumstances on the amendment.

    (b) Unless the circumstances in paragraph 12 apply:

        (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report; and

        (ii) Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

12. Where law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 11(b)(i) to that amendment. In such cases, the auditor shall either:

    (a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or (Ref: Para. A12)

    (b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph [4] or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

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[3] HKSA 580, "Written Representations."

[4] See HKSA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report."

13. In some jurisdictions, management may not be required by law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, if management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: (Ref: Para. A13-A14)

    (a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by HKSA 705 [5] and then provide the auditor's report; or

    (b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref. Para: A15-A16)

Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued

14. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, if, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

    (a) Discuss the matter with management and, where appropriate, those charged with governance;

    (b) Determine whether the financial statements need amendment; and, if so,

    (c) Inquire how management intends to address the matter in the financial statements.

15. If management amends the financial statements, the auditor shall: (Ref: Para. A17)

    (a) Carry out the audit procedures necessary in the circumstances on the amendment.

    (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.

    (c) Unless the circumstances in paragraph 12 apply:

        (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report, and date the new auditor's report no earlier than the date of approval of the amended financial statements; and

        (ii) Provide a new auditor's report on the amended financial statements.

    (d) When the circumstances in paragraph 12 apply, amend the auditor's report, or provide a new auditor's report as required by paragraph 12.

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[5] HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report."

16. The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity,[6] those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref: Para. A18)

Conformity and Compliance with International Standards on Auditing

18. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 560, "Subsequent Events". Compliance with the requirements of this HKSA ensures compliance with ISA 560.

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Application and Other Explanatory Material

Scope of this HKSA (Ref: Para. 1)

A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements, the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.[7]

Definitions

Date of Approval of the Financial Statements (Ref: Para. 5(b))

A2. In some jurisdictions, law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In other jurisdictions, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalizing its financial statements in view of its management and governance structures. In some jurisdictions, final approval of the financial statements by shareholders is required. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the HKSAs is the earlier date on which those with the recognized authority determine that all the statements that comprise the financial statements, including

[6] HKSA 260, "Communication with Those Charged with Governance," paragraph 13.

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

the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Date of the Auditor's Report (Ref: Para. 5(c))

A3. The auditor's report cannot be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements, including evidence that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for those financial statements.[8] Consequently, the date of the auditor's report cannot be earlier than the date of approval of the financial statements as defined in paragraph 5(b). A time period may elapse due to administrative issues between the date of the auditor's report as defined in paragraph 5(c) and the date the auditor's report is provided to the entity.

Date the Financial Statements Are Issued (Ref: Para. 5(d))

A4. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

Considerations Specific to Public Sector Entities

A5. In the case of the public sector, the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public.

Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report (Ref: Para. 6-9)

A6. Depending on the auditor's risk assessment, the audit procedures required by paragraph 6 may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required by paragraphs 6 and 7 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial statements, such as cutoff procedures or procedures in relation to subsequent receipts of accounts receivable).

A7. Paragraph 7 stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. Where the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inspection of available books and records, including bank statements. Paragraph A8 gives examples of some of the additional matters that the auditor may consider in the course of these inquiries.

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[8] HKSA 700, paragraph 41. In some cases, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

HKSA 700
Issued September 2009; revised July 2010

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

Hong Kong Standard on Auditing 700

Forming an Opinion and Reporting on Financial Statements

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

The term "fair presentation framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

(i) Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or

(ii) Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in extremely rare circumstances.

The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.[5]

(c) Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.[6]

8. Reference to "financial statements" in this HKSA means "a complete set of general purpose financial statements, including the related notes." The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The requirements of the applicable financial reporting framework determine the form and content of the financial statements, and what constitutes a complete set of financial statements.

9. Reference to "Hong Kong Financial Reporting Standards" in this HKSA means Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants (HKICPA).

Requirements

Forming an Opinion on the Financial Statements

10. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.[7, 8]

11. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

(a) The auditor's conclusion, in accordance with HKSA 330, whether sufficient appropriate audit evidence has been obtained;[9]

(b) The auditor's conclusion, in accordance with HKSA 450, whether uncorrected misstatements are material, individually or in aggregate;[10] and

(c) The evaluations required by paragraphs 12-15.

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5 HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraph 13(a).

6 Paragraphs 35-36 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

7 HKSA 200, paragraph 11.

8 Paragraphs 35-36 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

9 HKSA 330, "The Auditor's Responses to Assessed Risks," paragraph 26.

10 HKSA 450, "Evaluation of Misstatements Identified during the Audit," paragraph 11.

12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A1-A3)

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

    (a) The financial statements adequately disclose the significant accounting policies selected and applied;

    (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

    (c) The accounting estimates made by management are reasonable;

    (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

    (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A4)

    (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12-13 shall also include whether the financial statements achieve fair presentation. The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of:

    (a) The overall presentation, structure and content of the financial statements; and

    (b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A5-A10)

Form of Opinion

16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

17. If the auditor:

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

    (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

    the auditor shall modify the opinion in the auditor's report in accordance with HKSA 705.

Auditor's Report for Audits Conducted in Accordance with Hong Kong Standards on Auditing

Title (Ref: Para. 21)

A15. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

Addressee (Ref: Para. 22)

A16. Law or regulation often specifies to whom the auditor's report is to be addressed in that particular jurisdiction. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.[14a]

Introductory Paragraph (Ref: Para. 23)

A17. The introductory paragraph states, for example, that the auditor has audited the accompanying financial statements of the entity, which comprise [state the title of each financial statement comprising the complete set of financial statements required by the applicable financial reporting framework, specifying the date or period covered by each financial statement] and the summary of significant accounting policies and other explanatory information.

A18. When the auditor is aware that the audited financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented. This helps users to identify the financial statements to which the auditor's report relates.

A19. The auditor's opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. For example, in the case of many general purpose frameworks, the financial statements include: a balance sheet, an income statement, a statement of changes in equity, a cash flow statement, and a summary of significant accounting policies and other explanatory information. In some jurisdictions additional information might also be considered to be an integral part of the financial statements.

Management's Responsibility for the Financial Statements (Ref: Para. 26)

A20. HKSA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with HKSAs is conducted.[15] Management and, where appropriate, those charged with governance accept responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted.

[14a] In Hong Kong, auditors of a company incorporated under the Hong Kong Companies Ordinance have a statutory duty to make a report to the shareholders of the company on the company's financial statements.

[15] HKSA 200, paragraph 13(j).

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 43)

A42. HKSA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to HKSAs.[22] Where this is the case, the auditor may be obliged to use a layout or wording in the auditor's report that differs from that described in this HKSA. As explained in paragraph 4, consistency in the auditor's report, when the audit has been conducted in accordance with HKSAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. When the differences between the legal or regulatory requirements and HKSAs relate only to the layout and wording of the auditor's report and, at a minimum, each of the elements identified in paragraph 43(a)-(i) are included in the auditor's report, the auditor's report may refer to Hong Kong Standards on Auditing. Accordingly, in such circumstances the auditor is considered to have complied with the requirements of HKSAs, even when the layout and wording used in the auditor's report are specified by legal or regulatory reporting requirements. Where specific requirements in a particular jurisdiction do not conflict with HKSAs, adoption of the layout and wording used in this HKSA assists users of the auditor's report more readily to recognize the auditor's report as a report on an audit conducted in accordance with HKSAs. (HKSA 210 deals with circumstances where law or regulation prescribes the layout or wording of the auditor's report in terms that are significantly different from the requirements of HKSAs.)

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and Hong Kong Standards on Auditing (Ref: Para. 44)

A43. The auditor may refer in the auditor's report to the audit having been conducted in accordance with both Hong Kong Standards on Auditing as well as other auditing standards when, in addition to complying with the relevant other auditing standards, the auditor complies with each of HKSAs relevant to the audit.[23]

A44. A reference to both Hong Kong Standards on Auditing and other auditing standards is not appropriate if there is a conflict between the requirements in HKSAs and those in the other auditing standards that would lead the auditor to form a different opinion or not to include an Emphasis of Matter paragraph that, in the particular circumstances, is required by HKSAs. For example, some other auditing standards prohibit the auditor from including an Emphasis of Matter paragraph to highlight a going concern problem, whereas HKSA 570 requires the auditor to add an Emphasis of Matter paragraph in such circumstances.[24] In such a case, the auditor's report refers only to the auditing standards (either Hong Kong Standards on Auditing or the other auditing standards) in accordance with which the auditor's report has been prepared.

Supplementary Information Presented with the Financial Statements (Ref: Para. 46-47)

A45. In some circumstances, the entity may be required by law, regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by the applicable financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the applicable financial reporting framework or to provide further explanation of specific financial statement items. Such information is normally presented in either supplementary schedules or as additional notes.

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[22] HKSA 200, paragraph A55.

[23] HKSA 200, paragraph A56.

[24] HKSA 570, "Going Concern," paragraph 19.

A46. The auditor's opinion covers supplementary information that cannot be clearly differentiated from the financial statements because of its nature and how it is presented. For example, this would be the case when the notes to the financial statements include an explanation of the extent to which the financial statements comply with another financial reporting framework. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.

A47. Supplementary information that is covered by the auditor's opinion does not need to be specifically referred to in the introductory paragraph of the auditor's report when the reference to the notes in the description of the statements that comprise the financial statements in the introductory paragraph is sufficient.

A48. Law or regulation may not require that the supplementary information be audited, and management may decide not to ask the auditor to include the supplementary information within the scope of the audit of the financial statements.

A49. The auditor's evaluation whether unaudited supplementary information is presented in a manner that could be construed as being covered by the auditor's opinion includes, for example, where that information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly labeled as "unaudited."

A50. Management could change the presentation of unaudited supplementary information that could be construed as being covered by the auditor's opinion, for example, by:

- Removing any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.

- Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum place the unaudited notes together at the end of the required notes to the financial statements and clearly label them as unaudited. Unaudited notes that are intermingled with the audited notes can be misinterpreted as being audited.

A51. The fact that supplementary information is unaudited does not relieve the auditor of the responsibility to read that information to identify material inconsistencies with the audited financial statements. The auditor's responsibilities with respect to unaudited supplementary information are consistent with those described in HKSA 720.[25]

[25] HKSA 720, "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements."

<u>Illustration 1:</u>

Circumstances include the following:

- **Audit of a complete set of financial statements.**
- **The financial statements are prepared for a general purpose by directors of the entity in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[1a]

[Report on the Financial Statements][1]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][1b] as at 31 December 20X1, and the [income statement][statement of comprehensive income][1b], statement of changes in equity and [cash flow statement][statement of cash flows][1b] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' [2] *Responsibility for the Financial Statements*

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[3a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

[1a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[1] The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[1b] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[2] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

[3] Not used.

[3a] Auditors 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".

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[5] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Opinion

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

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[1]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

4 Not used

5 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

Illustration 2:

Circumstances include the following:

- **Audit of a complete set of financial statements required by law or regulation.**
- **The financial statements are prepared for a general purpose by management of the entity in accordance with the Financial Reporting Framework (XYZ Law) of Jurisdiction X (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][5a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][5a], statement of changes in equity and [cash flow statement][statement of cash flows][5a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's [6] Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with XYZ Law of Jurisdiction X, and for such internal control as the management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[6a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's

[5a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[6] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

[6a] Auditors 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".

internal control.[7] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the presentation of the financial statements.

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

Opinion

In our opinion, the financial statements of the Company for the year ended 31 December 20X1 are prepared, in all material respects, in accordance with XYZ Law of Jurisdiction X.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

[7] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances."

<u>Illustration 3:</u>

Circumstances include the following:

- **Audit of consolidated financial statements prepared for a general purpose by directors of the parent in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the group audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **In addition to the audit of the group financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[7a]

[Report on the Consolidated Financial Statements][8]

We have audited the consolidated financial statements of ABC Limited ("the Company") and its subsidiaries (together "the Group") set out on pages …… to …..., which comprise the consolidated and company [balance sheets][statements of financial position][8a] as at 31 December 20X1, and the consolidated [income statement][statement of comprehensive income][8a], the consolidated statement of changes in equity and the consolidated [cash flow statement][statement of cash flows][8a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[9] *Responsibility for the Consolidated Financial Statements*

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

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit[10a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with

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7a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

8 The sub-title "Report on the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

8a Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

9 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

10 Not used.

10a Auditors 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".

ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[12] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated financial statements.

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

Opinion

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

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[8]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

11 Not used

12 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

<u>Illustration 4:</u>

Circumstances include the following:

- **Audit of a complete set of financial statements.**
- **The financial statements are prepared for a general purpose by directors of the entity in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The entity is incorporated overseas and has reporting in Hong Kong.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [country or place] with limited liability)[13]

[Report on the Financial Statements][14]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ….., which comprise the [balance sheet][statement of financial position][15] as at 31 December 20X1, and the [income statement][statement of comprehensive income][15], statement of changes in equity and [cash flow statement][statement of cash flows][15] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[16] Responsibility for the Financial Statements

The directors are responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants [17] [and the disclosure requirements of the Hong Kong Companies Ordinance [18]], and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

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13 In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

14 The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

15 Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

16 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

17 It may be necessary to refer to International Financial Reporting Standards or other national accounting standards and/or other national legal requirements depending on the jurisdiction in which the company is incorporated.

18 For a company incorporated overseas and listed in Hong Kong, the disclosure requirements of the Hong Kong Companies Ordinance are applicable.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit [19]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control [20]. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Opinion

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

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[14]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

[19] Auditors 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".

[20] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

HKSA 705
Issued September 2009, revised July 2010

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

Hong Kong Standard on Auditing 705

Modifications to the Opinion in the Independent Auditor's Report

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

Communication with Those Charged with Governance

28. When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the proposed wording of the modification. (Ref: Para. A25)

Conformity and Compliance with International Standards on Auditing

29. As of September 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 705 "Modifications to the Opinion in the Independent Auditor's Report" except for the different wording in the description of auditor's responsibility when the auditor disclaims an opinion in paragraph 27 due to the Hong Kong statutory requirement. With the exception of the foregoing difference, as explained in footnote 3a, compliance with the requirements of this HKSA ensures compliance with ISA 705.

30. Additional local guidance is provided in footnote 3a and Appendix.

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Application and Other Explanatory Material

Types of Modified Opinions (Ref: Para. 2)

A1. The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	*Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements*	
	Material but Not Pervasive	*Material and Pervasive*
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Nature of Material Misstatements (Ref: Para. 6(a))

A2. HKSA 700 requires the auditor, in order to form an opinion on the financial statements, to conclude as to whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement.[4] This conclusion takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements in accordance with HKSA 450.[5]

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4 HKSA 700, paragraph 11.

5 HKSA 450, "Evaluation of Misstatements Identified during the Audit," paragraph 11.

Illustration 1:

Circumstances include the following:

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**[1]
- **Inventories are misstated. The misstatement is deemed to be material but not pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[1a]

[Report on the Financial Statements][2]

We have audited the financial statements of ABC Limited (the "Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][2a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][2a], statement of changes in equity and [cash flow statement][statement of cash flows][2a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[3] *Responsibility for the Financial Statements*

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

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1 HKSA 210, "Agreeing the Terms of Audit Engagements."

1a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

2 The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

2a Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

3 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

4 Not used.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[4a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[6] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

The Company's inventories are carried in the [balance sheet][statement of financial position][2a] at xxx. The directors have not stated the inventories at the lower of cost and net realizable value but have stated them solely at cost, which constitutes a departure from Hong Kong Financial Reporting Standards. The Company's records indicate that had the directors stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

Qualified Opinion

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

[4a] Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

[5] Not used.

[6] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[2]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

<u>Illustration 2:</u>

Circumstances include the following:

- **Audit of consolidated general purpose financial statements prepared by the directors of the parent in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The financial statements are materially misstated due to the non-consolidation of a subsidiary. The material misstatement is deemed to be pervasive to the financial statements. The effects of the misstatement on the financial statements have not been determined because it was not practicable to do so.**
- **In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance. Assume compliance with Hong Kong Companies Ordinance on non-consolidation of a subsidiary.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[6a]

[Report on the Consolidated Financial Statements][7]

We have audited the consolidated financial statements of ABC Limited (the "Company") and its subsidiaries (together "the Group") set out on pages …… to ……, which comprise the consolidated and company [balance sheets][statements of financial position][7a] as at 31 December 20X1, and the consolidated [income statement][statement of comprehensive income][7a], the consolidated statement of changes in equity and the consolidated [cash flow statement][statement of cash flows][7a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[8] *Responsibility for the Consolidated Financial Statements*

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

[6a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[7] The sub-title "Report on the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[7a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[8] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

[9] Not used.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit[9a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[11] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the consolidated financial statements.

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

Basis for Adverse Opinion

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

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 20X1, and of the Group's [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards. In all other respects, in our opinion the consolidated financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance.[11a]

[9a] Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

[10] Not used.

[11] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of consolidated financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

[11a] Assume the consolidated financial statements have been properly prepared in accordance with the Hong Kong Companies Ordinance in all other respects.

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[7]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

Illustration 3:

Circumstances include the following:

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material but not pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor has no other reporting responsibilities required under local law except for the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[11b]

Report on the Financial Statements

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][12a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][12a], statement of changes in equity and [cash flow statement][statement of cash flows][12a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[13] *Responsibility for the Financial Statements*

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

[11b] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[12] Not used.

[12a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[13] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

[14] Not used.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[14a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[16] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

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

Qualified Opinion

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

[14a] Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

[15] Not used.

[16] In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

Report on matters under sections 141(4) and 141(6) of the Hong Kong Companies Ordinance [16a]

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate:

- we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- we were unable to determine whether proper books of account had been kept.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

[16a] For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 "Reports by auditors under the Hong Kong Companies Ordinance".

<u>Illustration 4:</u>

Circumstances include the following:

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the company's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor has no other reporting responsibilities required under local law except for the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[16b]

Report on the Financial Statements

We were engaged to audit the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][17a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][17a], statement of changes in equity and [cash flow statement][statement of cash flows][17a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[18] *Responsibility for the Financial Statements*

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

16b In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

17 Not used.

17a Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

18 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

19 Not used.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[19a]. Except for the inability to obtain sufficient appropriate audit evidence as explained below, we conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.[19b] Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

The Company's investment in its joint venture DEF (Country X) Limited is carried at xxx on the Company's [balance sheet][statement of financial position][17a], which represents over 90% of the Company's net assets as at 31 December 20X1. We were not allowed access to the management and the auditors of DEF, including DEF's auditors' audit documentation. As a result, we were unable to determine whether any adjustments were necessary in respect of the Company's proportional share of DEF's assets that it controls jointly, its proportional share of DEF's liabilities for which it is jointly responsible, its proportional share of DEF's income and expenses for the year, and the elements making up the statement of changes in equity and [cash flow statement][statement of cash flows].[17a]

Disclaimer of Opinion

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

Report on matters under sections 141(4) and 141(6) of the Hong Kong Companies Ordinance [19c]

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a joint venture:

- we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- we were unable to determine whether proper books of account had been kept.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

19a Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

19b In Hong Kong, an auditor of a company incorporated under the Hong Kong Companies Ordinance has a statutory duty to make a report to the members of the company on the company's annual financial statements. Accordingly, an auditor in Hong Kong adheres to the requirements under paragraphs 29 and 30 of HKSA 700 which require that the auditor's report should state the auditor's responsibility and give details of the basis of an audit. Illustrations 4 and 5 of the Appendix reflect the auditor's duty under the Hong Kong Companies Ordinance.

19c For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 "Reports by auditors under the Hong Kong Companies Ordinance".

<u>Illustration 5:</u>

Circumstances include the following:

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.**
- **The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements. That is, the auditor was unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.**
- **In addition to the audit of the financial statements, the auditor has no other reporting responsibilities required under local law except for the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[19d]

Report on the Financial Statements

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

Directors'[21] *Responsibility for the Financial Statements*

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[22a]. Except for the inability to obtain sufficient appropriate audit evidence as explained below, we conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and

[19d] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.
[20] Not used.
[20a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.
[21] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.
[22] Not used.
[22a] Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.[22b] Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after 31 December 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 31 December 20X0 and 20X1 which are stated in the [balance sheet][statement of financial position][20a] at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, the directors were still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the [balance sheet][statement of financial position][20a] at a total amount of xxx as at 31 December 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the [income statement][statement of comprehensive income][20a], statement of changes in equity and [cash flow statement][statement of cash flows].[20a]

Disclaimer of Opinion

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

Report on matters under sections 141 (4) and 141 (6) of the Hong Kong Companies Ordinance [22c]

In respect alone of the inability to obtain sufficient appropriate audit evidence about the inventories and accounts receivable:

- we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- we were unable to determine whether proper books of account had been kept.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

[22b] In Hong Kong, an auditor of a company incorporated under the Hong Kong Companies Ordinance has a statutory duty to make a report to the members of the company on the company's annual financial statements. Accordingly, an auditor in Hong Kong adheres to the requirements under paragraphs 29 and 30 of HKSA 700 which require that the auditor's report should state the auditor's responsibility and give details of the basis of an audit. Illustrations 4 and 5 of the Appendix reflect the auditor's duty under the Hong Kong Companies Ordinance.

[22c] For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 "Reports by auditors under the Hong Kong Companies Ordinance".

HKSA 706
Issued September 2009; revised July 2010

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

Hong Kong Standard on Auditing 706

Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

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

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with additional communication in the auditor's report when the auditor considers it necessary to:

   (a) Draw users' attention to a matter or matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements; or

   (b) Draw users' attention to any matter or matters other than those presented or disclosed in the financial statements that are relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

2. Appendices 1 and 2 identify HKSAs that contain specific requirements for the auditor to include Emphasis of Matter paragraphs or Other Matter paragraphs in the auditor's report. In those circumstances, the requirements in this HKSA regarding the form and placement of such paragraphs apply.

Effective Date

3. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Objective

4. The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to:

   (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or

   (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Definitions

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

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

   (b) Other Matter paragraph – A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Appendix 3

(Ref: Para. A4)

Illustration of an Auditor's Report that Includes an Emphasis of Matter Paragraph

Circumstances include the following:

- **Audit of a complete set of general purpose financial statements prepared by the directors of the entity in accordance with Hong Kong Financial Reporting Standards.**
- **The terms of the audit engagement reflect the description of directors' responsibility for the financial statements in HKSA 210.[1]**
- **There is uncertainty relating to a pending exceptional litigation matter.**
- **A departure from the applicable financial reporting framework resulted in a qualified opinion.**
- **In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[1a]

[Report on the Financial Statements][2]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][2a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][2a], statement of changes in equity and [cash flow statement][statement of cash flows][2a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[3] Responsibility for the Financial Statements

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

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1 HKSA 210, "Agreeing the Terms of Audit Engagements."

1a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

2 The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

2a Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

3 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

4 Not used.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[4a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[6] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the [balance sheet][statement of financial position][2a] at xxx. The directors have not marked these securities to market but have instead stated them at cost, which constitutes a departure from Hong Kong Financial Reporting Standards. The Company's records indicate that had the directors marked the marketable securities to market, the Company would have recognized an unrealized loss of xxx in the [income statement][statement of comprehensive income][2a] for the year. The carrying amount of the securities in the [balance sheet][statement of financial position][2a] would have been reduced by the same amount at 31 December 20X1, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

Qualified Opinion

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

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the uncertainty [7] related to the outcome of the lawsuit filed against the Company by DEF Company. Our opinion is not qualified in respect of this matter.

4a Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

5 Not used.

6 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

7 In highlighting the uncertainty, the auditor uses the same terminology that is used in the note to the financial statements.

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[2]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

HKSA 710
Issued September 2009; revised July 2010

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

Hong Kong Standard on Auditing 710

Comparative Information—Corresponding Figures and Comparative Financial Statements

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

Appendix 1

Illustrations of Auditors' Reports

Illustration 1 - Corresponding Figures (Ref: Para. A5)

Report illustrative of the circumstances described in paragraph 11(a), as follows:

- **The auditor's report on the prior period, as previously issued, included a qualified opinion.**
- **The matter giving rise to the modification is unresolved.**
- **The effects or possible effects of the matter on the current period's figures are material and require a modification to the auditor's opinion regarding the current period figures.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[1a]

[Report on the Financial Statements][1]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][1b] as at 31 December 20X1, and the [income statement][statement of comprehensive income][1b], statement of changes in equity and [cash flow statement][statement of cash flows][1b] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors'[2] *Responsibility for the Financial Statements*

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit[3a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

1a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

1 The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

1b Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

2 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

3 Not used.

3a Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[5] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which constitutes a departure from Hong Kong Financial Reporting Standards. This is the result of a decision taken by the directors at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 20X1 and xxx in 20X0, property, plant and equipment should be reduced by accumulated depreciation of xxx in 20X1 and xxx in 20X0, and the accumulated loss should be increased by xxx in 20X1 and xxx in 20X0.

Qualified Opinion

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

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[1]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

4 Not used.

5 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

Illustration 2 - Corresponding Figures (Ref: Para. A5)

Report illustrative of the circumstances described in paragraph 11(b), as follows:

- **The auditor's report on the prior period, as previously issued, included a qualified opinion.**
- **The matter giving rise to the modification is unresolved.**
- **The effects or possible effects of the matter on the current period's figures are immaterial but require a modification to the auditor's opinion because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[5a]

[Report on the Financial Statements][6]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][6a] as at 31 December 20X1, and the [income statement][statement of comprehensive income],[6a] statement of changes in equity and [cash flow statement][statement of cash flows][6a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' [7] *Responsibility for the Financial Statements*

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit [8a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

5a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

6 The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

6a Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

7 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

8 Not used.

8a Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[10] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

Because we were appointed auditors of ABC Limited during 20X0, we were not able to observe the counting of the physical inventories at the beginning of that period or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories affect the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 20X0. Our audit opinion on the financial statements for the period ended 31 December 20X0 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.

Qualified Opinion

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

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[6]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

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9 Not used.

10 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

Illustration 3 - Corresponding Figures: (Ref: Para. A7)

Report illustrative of the circumstances described in paragraph 13, as follows:

- **The prior period's financial statements were audited by a predecessor auditor.**
- **The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so.**

INDEPENDENT AUDITOR'S REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in Hong Kong with limited liability)[10a]

[Report on the Financial Statements][11]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][11a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][11a], statement of changes in equity and [cash flow statement][statement of cash flows][11a] for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' [12] *Responsibility for the Financial Statements*

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit [13a]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

[10a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[11] The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[11a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[12] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

[13] Not used.

[13a] Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[15] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Opinion

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

Other Matter

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

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[11]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

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14 Not used.

15 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

Illustration 4 - Comparative Financial Statements[15a]: (Ref: Para. A9)

Report illustrative of the circumstances described in paragraph 15, as follows:

- **Auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year's audit.**
- **The auditor's report on the prior period, as previously issued, included a qualified opinion.**
- **The matter giving rise to the modification is unresolved.**
- **The effects or possible effects of the matter on the current period's figures are material to both the current period financial statements and prior period financial statements and require a modification to the auditor's opinion.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

[Report on the Financial Statements][16]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statements of financial position][16a] as at 31 December 20X1 and 20X0, and the [income statement][statements of comprehensive income][16a], statements of changes in equity and [cash flow statement][statements of cash flows][16a] for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's [17] *Responsibility for the Financial Statements*

Management is responsible for the preparation of financial statements that give a true and fair view in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Accountants, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits[18a]. We conducted our audits in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

15a The comparative financial statements as presented in this Illustration are not generally applicable to an audit performed on a Hong Kong incorporated company's annual statutory financial statements, refer to Appendix 2.

16 The sub-title "Report on the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

16a Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

17 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

18 Not used.

18a Auditors 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 "Auditors' Duty of Care To Third Parties and The Audit Report".

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[20] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which constitutes a departure from Hong Kong Financial Reporting Standards. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 20X1 and xxx in 20X0, property, plant and equipment should be reduced by accumulated depreciation of xxx in 20X1 and xxx in 20X0, and the accumulated loss should be increased by xxx in 20X1 and xxx in 20X0.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X1 and 20X0 and of its [profit][loss] and cash flows for the years then ended in accordance with Hong Kong Financial Reporting Standards.

[Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]**]**[16]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

Date of the auditor's report

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19 Not used.

20 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

HKSA 720
Issued September 2009; revised July 2010

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

Hong Kong Standard on Auditing 720

The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements

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

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion does not cover other information and the auditor has no specific responsibility for determining whether or not other information is properly stated. However, the auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. (Ref: Para. A1)

2. In this HKSA "documents containing audited financial statements" refers to annual reports (or similar documents), that are issued to owners (or similar stakeholders), containing audited financial statements and the auditor's report thereon. This HKSA may also be applied, adapted as necessary in the circumstances, to other documents containing audited financial statements, such as those used in securities offerings.[1] (Ref: Para. A2)

Effective Date

3. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2009.

Objective

4. The objective of the auditor is to respond appropriately when documents containing audited financial statements and the auditor's report thereon include other information that could undermine the credibility of those financial statements and the auditor's report.

Definitions

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

   (a) Other information – Financial and non-financial information (other than the financial statements and the auditor's report thereon) which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report thereon. (Ref: Para. A3-A4)

   (b) Inconsistency – Other information that contradicts information contained in the audited financial statements. A material inconsistency may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's opinion on the financial statements.

   (c) Misstatement of fact – Other information that is unrelated to matters appearing in the audited financial statements that is incorrectly stated or presented. A material misstatement of fact may undermine the credibility of the document containing audited financial statements.

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

Requirements

Reading Other Information

6. The auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

7. The auditor shall make appropriate arrangements with management or those charged with governance to obtain the other information prior to the date of the auditor's report. If it is not possible to obtain all the other information prior to the date of the auditor's report, the auditor shall read such other information as soon as practicable. (Ref: Para. A5)

Material Inconsistencies [1a]

8. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the audited financial statements or the other information needs to be revised.

Material Inconsistencies Identified in Other Information Obtained Prior to the Date of the Auditor's Report

9. If revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in the auditor's report in accordance with HKSA 705.[2]

10. If revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance, unless all of those charged with governance are involved in managing the entity;[3] and

    (a) Include in the auditor's report an Other Matter paragraph describing the material inconsistency in accordance with HKSA 706;[4]

    (b) Withhold the auditor's report; or

    (c) Withdraw from the engagement, where withdrawal is possible under applicable law or regulation. (Ref: Para. A6-A7)

Material Inconsistencies Identified in Other Information Obtained Subsequent to the Date of the Auditor's Report

11. If revision of the audited financial statements is necessary, the auditor shall follow the relevant requirements in HKSA 560.[5]

12. If revision of the other information is necessary and management agrees to make the revision, the auditor shall carry out the procedures necessary under the circumstances. (Ref: Para. A8)

[1a] Additional local guidance is provided in Appendix.

[2] HKSA 705, "Modifications to the Opinion in the Independent Auditor's Report."

[3] HKSA 260, "Communication with Those Charged with Governance," paragraph 13.

[4] HKSA 706, "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report," paragraph 8.

[5] HKSA 560, "Subsequent Events," paragraphs 10-17.

HKSA 800

Issued October 2009; revised July 2010

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

Hong Kong Standard on Auditing 800

Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

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

A7. Where the financial reporting standards referred to in paragraph A6 are supplemented by legislative or regulatory requirements, HKSA 210 requires the auditor to determine whether any conflicts between the financial reporting standards and the additional requirements exist, and prescribes actions to be taken by the auditor if such conflicts exist.[9]

A8. The applicable financial reporting framework may encompass the financial reporting provisions of a contract, or sources other than those described in paragraphs A6 and A7. In that case, the acceptability of the financial reporting framework in the circumstances of the engagement is determined by considering whether the framework exhibits attributes normally exhibited by acceptable financial reporting frameworks as described in Appendix 2 of HKSA 210. In the case of a special purpose framework, the relative importance to a particular engagement of each of the attributes normally exhibited by acceptable financial reporting frameworks is a matter of professional judgment. For example, for purposes of establishing the value of net assets of an entity at the date of its sale, the vendor and the purchaser may have agreed that very prudent estimates of allowances for uncollectible accounts receivable are appropriate for their needs, even though such financial information is not neutral when compared with financial information prepared in accordance with a general purpose framework.

Considerations When Planning and Performing the Audit (Ref: Para. 9)

A9. HKSA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all HKSAs relevant to the audit. It also requires the auditor to comply with each requirement of an HKSA unless, in the circumstances of the audit, the entire HKSA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an HKSA by performing alternative audit procedures to achieve the aim of that requirement.[10]

A10. Application of some of the requirements of the HKSAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in HKSA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.[11] In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.

A11. In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with HKSA 320 for purposes of planning and performing the audit of the special purpose financial statements.

A12. Communication with those charged with governance in accordance with HKSAs is based on the relationship between those charged with governance and the financial statements subject to audit, in particular, whether those charged with governance are responsible for overseeing the preparation of those financial statements. In the case of special purpose financial statements, those charged with governance may not have such a responsibility; for example, when the financial information is prepared solely for management's use. In such cases, the requirements

9 HKSA 210, paragraph 18.

10 HKSA 200, paragraphs 14, 18, and 22-23.

11 HKSA 320, "Materiality in Planning and Performing an Audit," paragraph 2.

Illustration 1:

Circumstances include the following:

- **The financial statements have been prepared by management of the entity in accordance with the financial reporting provisions of a contract (that is, a special purpose framework) to comply with the provisions of that contract. Management does not have a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a compliance framework.**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.**
- **Distribution and use of the auditor's report are restricted.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][1a] as at 31December 20X1, and the [income statement][statement of comprehensive income][1a], statement of changes in equity and [cash flow statement][statement of cash flows][1a] for the year then ended, and a summary of significant accounting policies and other explanatory information. The financial statements have been prepared by management of the Company based on the financial reporting provisions of Section Z of the contract dated 1 January 20X1 between the Company and DEF Company ("the contract").

Management's[1] Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the financial reporting provisions of Section Z of the contract, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

[1a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[1] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements of the Company for the year ended 31 December 20X1 are prepared, in all material respects, in accordance with the financial reporting provisions of Section Z of the contract.

Basis of Accounting and Restriction on Distribution and Use

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company to comply with the financial reporting provisions of the contract referred to above. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Company and DEF Company and should not be distributed to or used by parties other than the Company or DEF Company[1b].

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]

[1b] Auditors 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:

Circumstances include the following:

- **The financial statements have been prepared by management of a partnership in accordance with the tax basis of accounting in Jurisdiction X (that is, a special purpose framework) to assist the partners in preparing their individual income tax returns. Management does not have a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a compliance framework.**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.**
- **Distribution of the auditor's report is restricted.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the financial statements of ABC Partnership ("the Partnership") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][1c] as at 31 December 20X1 and the [income statement][statement of comprehensive income][1c] for the year then ended, and a summary of significant accounting policies and other explanatory information. The financial statements have been prepared by management using the tax basis of accounting in Jurisdiction X.

Management's[2] Responsibility for the Financial Statements

Management is responsible for the preparation of these financial statements in accordance with the tax basis of accounting in Jurisdiction X, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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

[1c] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[2] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

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

Opinion

In our opinion, the financial statements of the Partnership for the year ended 31 December 20X1 are prepared, in all material respects, in accordance with [describe the applicable income tax law] of Jurisdiction X.

Basis of Accounting and Restriction on Distribution

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the partners of the Partnership in preparing their individual income tax returns. As a result, the financial statements may not be suitable for another purpose. Our report is intended solely for the Partnership and its partners and should not be distributed to parties other than the Partnership or its partners[2a].

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]

[2a] Auditors 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:

Circumstances include the following:

- **The financial statements have been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator (that is, a special purpose framework) to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a fair presentation framework.**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.**
- **Distribution or use of the auditor's report is not restricted.**
- **The Other Matter paragraph refers to the fact that the auditor has also issued an auditor's report on financial statements prepared by ABC Limited for the same period in accordance with a general purpose framework.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the financial statements of ABC Limited ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][2b] as at 31 December 20X1, and the [income statement][statement of comprehensive income][2b], statement of changes in equity and [cash flow statement][statement of cash flows][2b] for the year then ended, and a summary of significant accounting policies and other explanatory information. The financial statements have been prepared by management based on the financial reporting provisions of Section Y of Regulation Z.

Management's[3] Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with the financial reporting provisions of Section Y of Regulation Z,[4] and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

2b Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

3 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

4 Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with the financial reporting provisions of section Y of Regulation Z, and for such …"

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation[5] of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[6] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at 31 December 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with the financial reporting provisions of Section Y of Regulation Z.

Basis of Accounting

Without modifying our opinion, we draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company to meet the requirements of Regulator DEF. As a result, the financial statements may not be suitable for another purpose[6a].

Other Matter

The Company has prepared a separate set of financial statements for the year ended 31 December 20X1 in accordance with Hong Kong Financial Reporting Standards on which we issued a separate auditor's report to the shareholders of the Company dated 31 March 20X2.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]

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5 In the case of footnote 4, this may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control."

6 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances." In the case of footnote 16, this may read: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances."

6a Auditors 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".

HKSA 805
Issued October 2009; revised July 2010

Effective for audits for periods
beginning on or after 15 December 2009

Hong Kong Standard on Auditing 805

Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

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

(c) A single financial statement or to a specific element of a financial statement includes the related notes. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information relevant to the financial statement or to the element.

Requirements

Considerations When Accepting the Engagement

Application of HKSAs

7. HKSA 200 requires the auditor to comply with all HKSAs relevant to the audit.[3] In the case of an audit of a single financial statement or of a specific element of a financial statement, this requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements. If the auditor is not also engaged to audit the entity's complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with HKSAs is practicable. (Ref: Para. A5-A6)

Acceptability of the Financial Reporting Framework

8. HKSA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements.[4] In the case of an audit of a single financial statement or of a specific element of a financial statement, this shall include whether application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element. (Ref: Para. A7)

Form of Opinion

9. HKSA 210 requires that the agreed terms of the audit engagement include the expected form of any reports to be issued by the auditor.[5] In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances. (Ref: Para. A8-A9)

Considerations When Planning and Performing the Audit

10. HKSA 200 states that HKSAs are written in the context of an audit of financial statements; they are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.[6, 7] In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all HKSAs relevant to the audit as necessary in the circumstances of the engagement. (Ref: Para. A10-A14)

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3 HKSA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing," paragraph 18.

4 HKSA 210, "Agreeing the Terms of Audit Engagements," paragraph 6(a).

5 HKSA 210, paragraph 10(e).

6 HKSA 200, paragraph 2.

7 HKSA 200, paragraph 13(f), explains that the term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework.

Considerations When Accepting the Engagement

Application of HKSAs (Ref: Para. 7)

A5. HKSA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all HKSAs relevant to the audit. It also requires the auditor to comply with each requirement of an HKSA unless, in the circumstances of the audit, the entire HKSA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an HKSA by performing alternative audit procedures to achieve the aim of that requirement.[14]

A6. Compliance with the requirements of HKSAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. The auditor also does not have the audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records. In the case of an audit of a specific element of a financial statement, certain HKSAs require audit work that may be disproportionate to the element being audited. For example, although the requirements of HKSA 570[15] are likely to be relevant in the circumstances of an audit of a schedule of accounts receivable, complying with those requirements may not be practicable because of the audit effort required. If the auditor concludes that an audit of a single financial statement or of a specific element of a financial statement in accordance with HKSAs may not be practicable, the auditor may discuss with management whether another type of engagement might be more practicable.

Acceptability of the Financial Reporting Framework (Ref: Para. 8)

A7. A single financial statement or a specific element of a financial statement may be prepared in accordance with an applicable financial reporting framework that is based on a financial reporting framework established by an authorized or recognized standards setting organization for the preparation of a complete set of financial statements (for example, Hong Kong Financial Reporting Standards). If this is the case, determination of the acceptability of the applicable framework may involve considering whether that framework includes all the requirements of the framework on which it is based that are relevant to the presentation of a single financial statement or of a specific element of a financial statement that provides adequate disclosures.

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14 HKSA 200, paragraphs 14, 18, and 22-23.

15 HKSA 570, "Going Concern."

Form of Opinion (Ref: Para. 9)

A8. The form of opinion to be expressed by the auditor depends on the applicable financial reporting framework and any applicable laws or regulations.[16] In accordance with HKSA 700: [17]

(a) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion, unless otherwise required by law or regulation, uses one of the following phrases:

(i) the financial statements present fairly, in all material respects, in accordance with [the applicable financial reporting framework]; or

(ii) the financial statements give a true and fair view in accordance with [the applicable financial reporting framework]; and

(b) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a compliance framework, the auditor's opinion states that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

A9. In the case of a single financial statement or of a specific element of a financial statement, the applicable financial reporting framework may not explicitly address the presentation of the financial statement or of the element. This may be the case when the applicable financial reporting framework is based on a financial reporting framework established by an authorized or recognized standards setting organization for the preparation of a complete set of financial statements (for example, Hong Kong Financial Reporting Standards). The auditor therefore considers whether the expected form of opinion is appropriate in the light of the applicable financial reporting framework. Factors that may affect the auditor's consideration as to whether to use the phrases "presents fairly, in all material respects," or "gives a true and fair view" in the auditor's opinion include:

- Whether the applicable financial reporting framework is explicitly or implicitly restricted to the preparation of a complete set of financial statements.

- Whether the single financial statement or the specific element of a financial statement will:

  - Comply fully with each of those requirements of the framework relevant to the particular financial statement or the particular element, and the presentation of the financial statement or the element include the related notes.

  - If necessary to achieve fair presentation, provide disclosures beyond those specifically required by the framework or, in exceptional circumstances, depart from a requirement of the framework.

The auditor's decision as to the expected form of opinion is a matter of professional judgment. It may be affected by whether use of the phrases "presents fairly, in all material respects," or "gives a true and fair view" in the auditor's opinion on a single financial statement or on a specific element of a financial statement prepared in accordance with a fair presentation framework is generally accepted in the particular jurisdiction.

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16 HKSA 200, paragraph 8.

17 HKSA 700, paragraphs 35-36.

Illustration 1:

Circumstances include the following:

- **Audit of a balance sheet (that is, a single financial statement).**
- **The balance sheet has been prepared by management of the entity in accordance with the requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing a balance sheet.**
- **The applicable financial reporting framework is a fair presentation framework designed to meet the common financial information needs of a wide range of users.**
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.**
- **The auditor has determined that it is appropriate to use the phrase "presents fairly, in all material respects," in the auditor's opinion.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the accompanying [balance sheet][statement of financial position][1a] of ABC Limited ("the Company") as at 31 December 20X1 and a summary of significant accounting policies and other explanatory information (together "the financial statement").

Management's[1] Responsibility for the Financial Statement

Management is responsible for the preparation and fair presentation of this financial statement in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement, and for such internal control as management determines is necessary to enable the preparation of the financial statement that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on the financial statement based on our audit[1b]. We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statement is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statement. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statement, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statement in order to design audit procedures that

[1a] Delete as appropriate, different term may be used as long as it is consistent with the title of the corresponding statement.

[1] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

[1b] Auditors 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".

are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[2] An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, made by management, as well as evaluating the overall presentation of the financial statement.

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

Opinion

In our opinion, the financial statement presents fairly, in all material respects, the financial position of the Company as at 31 December 20X1 in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]

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2 In circumstances when the auditor also has responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statement, this sentence would be worded as follows: "In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statement in order to design audit procedures that are appropriate in the circumstances."

Illustration 2:

Circumstances include the following:

- **Audit of a statement of cash receipts and disbursements (that is, a single financial statement).**
- **The financial statement has been prepared by management of the entity in accordance with the cash receipts and disbursements basis of accounting to respond to a request for cash flow information received from a creditor. Management has a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a fair presentation framework designed to meet the financial information needs of specific users.**[3]
- **The auditor has determined that it is appropriate to use the phrase "presents fairly, in all material respects," in the auditor's opinion.**
- **Distribution or use of the auditor's report is not restricted.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the accompanying statement of cash receipts and disbursements of ABC Limited ("the Company") for the year ended 31 December 20X1 and a summary of significant accounting policies and other explanatory information (together "the financial statement"). The financial statement has been prepared by management using the cash receipts and disbursements basis of accounting described in Note X.

Management's[4] Responsibility for the Financial Statement

Management is responsible for the preparation and fair presentation of this financial statement in accordance with the cash receipts and disbursements basis of accounting described in Note X; this includes determining that the cash receipts and disbursements basis of accounting is an acceptable basis for the preparation of the financial statement in the circumstances, and for such internal control as management determines is necessary to enable the preparation of the financial statement that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

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3 HKSA 800 contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

4 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

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

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

Opinion

In our opinion, the financial statement presents fairly, in all material respects, the cash receipts and disbursements of the Company for the year ended 31 December 20X1 in accordance with the cash receipts and disbursements basis of accounting described in Note X.

Basis of Accounting

Without modifying our opinion, we draw attention to Note X to the financial statement, which describes the basis of accounting. The financial statement is prepared to provide information to XYZ Creditor. As a result, the statement may not be suitable for another purpose[4a].

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]

[4a] Auditors 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:

Circumstances include the following:

- **Audit of the liability for "incurred but not reported" claims in an insurance portfolio (that is, element, account or item of a financial statement).**
- **The financial information has been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.**
- **The applicable financial reporting framework is a compliance framework designed to meet the financial information needs of specific users.**[5]
- **The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.**
- **Distribution of the auditor's report is restricted.**

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited the accompanying schedule of the liability for "incurred but not reported" claims of ABC Insurance Company ("the Company") as at 31 December 20X1 ("the schedule"). The schedule has been prepared by management based on [describe the financial reporting provisions established by the regulator].

Management's[6] Responsibility for the Schedule

Management is responsible for the preparation of the schedule in accordance with [describe the financial reporting provisions established by the regulator], and for such internal control as management determines is necessary to enable the preparation of the schedule that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the schedule. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the schedule, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation of the schedule in order to design audit procedures that are appropriate in the

[5] HKSA 800 contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

[6] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the schedule.

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

Opinion

In our opinion, the financial information in the schedule of the liability for "incurred but not reported" claims of the Company as at 31 December 20X1 is prepared, in all material respects, in accordance with [describe the financial reporting provisions established by the regulator].

Basis of Accounting and Restriction on Distribution

Without modifying our opinion, we draw attention to Note X to the schedule, which describes the basis of accounting. The schedule is prepared to assist the Company to meet the requirements of Regulator DEF. As a result, the schedule may not be suitable for another purpose. Our report is intended solely for the Company and Regulator DEF and should not be distributed to parties other than the Company or Regulator DEF[6a].

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]

[6a] Auditors 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".

HKSA 810
Issued October 2009; revised July 2010

Effective for engagements
for periods beginning on or after 15 December 2009

Hong Kong Standard on Auditing 810

Engagements to Report on Summary Financial Statements

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

Comparatives

21. If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor shall determine whether such omission is reasonable in the circumstances of the engagement. The auditor shall determine the effect of an unreasonable omission on the auditor's report on the summary financial statements. (Ref: Para. A16)

22. If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that HKSA 710 requires the auditor to include in the auditor's report on the audited financial statements.[7] (Ref: Para. A17)

Unaudited Supplementary Information Presented with Summary Financial Statements

23. The auditor shall evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements. If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary financial statements, the auditor shall ask management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report. (Ref: Para. A18)

Other Information in Documents Containing Summary Financial Statements

24. The auditor shall read other information included in a document containing the summary financial statements and related auditor's report to identify material inconsistencies, if any, with the summary financial statements. If, on reading the other information, the auditor identifies a material inconsistency, the auditor shall determine whether the summary financial statements or the other information needs to be revised. If, on reading the other information, the auditor becomes aware of an apparent material misstatement of fact, the auditor shall discuss the matter with management. (Ref: Para. A19)

Auditor Association

25. If the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document. If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document. (Ref: Para. A20)

26. The auditor may be engaged to report on the financial statements of an entity, while not engaged to report on the summary financial statements. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor shall be satisfied that:

    (a) The reference to the auditor is made in the context of the auditor's report on the audited financial statements; and

    (b) The statement does not give the impression that the auditor has reported on the summary financial statements.

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[7] HKSA 710, "Comparative Information—Corresponding Figures and Comparative Financial Statements."

Timing of Work and Events Subsequent to the Date of the Auditor's Report on the Audited Financial Statements (Ref: Para. 12)

A10. The procedures described in paragraph 8 are often performed during or immediately after the audit of the financial statements. When the auditor reports on the summary financial statements after the completion of the audit of the financial statements, the auditor is not required to obtain additional audit evidence on the audited financial statements, or report on the effects of events that occurred subsequent to the date of the auditor's report on the audited financial statements since the summary financial statements are derived from the audited financial statements and do not update them.

Auditor's Report on Summary Financial Statements

Elements of the Auditor's Report

Title (Ref: Para. 14(a))

A11. A title indicating the report is the report of an independent auditor, for example, "Report of the Independent Auditor," affirms that the auditor has met all of the relevant ethical requirements regarding independence. This distinguishes the report of the independent auditor from reports issued by others.

Addressee (Ref: Para. 14(b), 15)

A12. Factors that may affect the auditor's evaluation of the appropriateness of the addressee of the summary financial statements include the terms of the engagement, the nature of the entity, and the purpose of the summary financial statements.

Introductory Paragraph (Ref: Para. 14(c)(i))

A13. When the auditor is aware that the summary financial statements will be included in a document that contains other information, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the summary financial statements are presented. This helps readers to identify the summary financial statements to which the auditor's report relates.

Date of the Auditor's Report (Ref: Para. 14(h), 16)

A14. The person or persons with recognized authority to conclude that the summary financial statements have been prepared and take responsibility for them depend on the terms of the engagement, the nature of the entity, and the purpose of the summary financial statements.

Illustrations (Ref: Para.14, 17-18,19)

A15. The Appendix to this HKSA contains illustrations of auditors' reports on summary financial statements that:

(a) Contain unmodified opinions;

(b) Are derived from audited financial statements on which the auditor issued modified opinions; and

(c) Contain a modified opinion.

Illustration 1:

Circumstances include the following:

- **An unmodified opinion is expressed on the audited financial statements.**
- **The summary financial report is prepared in accordance with section 141CF(1) of the Hong Kong Companies Ordinance and complies with the requirements of section 5 of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation.**
- **The auditor's report on the summary financial statements is dated later than the date of the auditor's report on the financial statements from which the summary financial statements are derived.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [Hong Kong] with limited liability)[1a]

The summary financial report of ABC Limited ("the Company") set out on pages … to …, which comprises the summary [balance sheet][statement of financial position][1b] as at 31 December 20X1[,][and] [1c] the summary [income statement][statement of comprehensive income][1b][, summary statement of changes in equity and summary [cash flow statement][statement of cash flows][1b]] for the year then ended, and related notes, are derived from the audited financial statements of the Company for the year ended 31 December 20X1. We expressed an unmodified audit opinion on those financial statements in our report dated 15 February 20X2. Those financial statements, and the summary financial report, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements.

The summary financial report does not contain all the disclosures required by Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants. Reading the summary financial report, therefore, is not a substitute for reading the audited financial statements of the Company.

Directors' [1] Responsibility for the Summary Financial Report

Under the Hong Kong Companies Ordinance, the directors are responsible for the preparation of a summary financial report in accordance with section 141CF(1) of the Hong Kong Companies Ordinance. In preparing the summary financial report, section 141CF(1) of the Hong Kong Companies Ordinance requires that the summary financial report be derived from the annual financial statements and the auditor's report thereon and the directors' report for the year ended 31 December 20X1, be in such form and contain such information and particulars as specified in section 5 of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation, and be approved by the board of directors.

[1a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[1b] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[1c] Section 5(3)(1) and (2) of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation states that a summary financial report of a listed company shall contain all the information and particulars included in the company's balance sheet and profit and loss account as they appear in the relevant documents; or the company's consolidated balance sheet and consolidated profit and loss account if the company is presenting group financial statements.

[1] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

Illustration 2:

Circumstances include the following:

- **An unmodified opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [Hong Kong] with limited liability)[1d]

The summary financial statements of ABC Limited ("the Company") set out on pages … to …, which comprise the summary [balance sheet][statement of financial position][1e] as at 31 December 20X1, the summary [income statement][statement of comprehensive income][1e], summary statement of changes in equity and summary [cash flow statement][statement of cash flows][1e] for the year then ended, and related notes, are derived from the audited financial statements of the Company for the year ended 31 December 20X1. We expressed an unmodified audit opinion on those financial statements in our report dated 15 February 20X2.[2]

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Limited for example, the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants.] Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of the Company.

Management's [3] Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Hong Kong Standard on Auditing (HKSA) 810, "Engagements to Report on Summary Financial Statements" issued by the Hong Kong Institute of Certified Public Accountants.

Opinion

In our opinion, the summary financial statements derived from the audited financial statements of the Company for the year ended 31 December 20X1 are consistent, in all material respects, with (or *a fair summary of*) those financial statements, on the basis described in Note X.

1d In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

1e Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

2 When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements."

3 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

<u>Illustration 3:</u>

Circumstances include the following:

- **A qualified opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [Hong Kong] with limited liability)[3a]

The summary financial statements of ABC Limited ("the Company") set out on pages … to …, which comprise the summary [balance sheet][statement of financial position][3b] as at 31 December 20X1, the summary [income statement][statement of comprehensive income][3b], summary statement of changes in equity and summary [cash flow statement][statement of cash flows][3b] for the year then ended, and related notes, are derived from the audited financial statements of the Company for the year ended 31 December 20X1.[4] We expressed a qualified audit opinion on those financial statements in our report dated 15 February 20X2 (see below).

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Limited for example, the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants.] Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of the Company.

Management's [5] Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Hong Kong Standard on Auditing (HKSA) 810, "Engagements to Report on Summary Financial Statements" issued by the Hong Kong Institute of Certified Public Accountants.

Opinion

In our opinion, the summary financial statements derived from the audited financial statements of the Company for the year ended 31 December 20X1 are consistent, in all material respects, with (or *a fair summary of*) those financial statements, on the basis described in Note X. However, the summary

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3a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

3b Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

4 When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements."

5 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

financial statements are misstated to the equivalent extent as the audited financial statements of the Company for the year ended 31 December 20X1.

The misstatement of the audited financial statements is described in our qualified audit opinion in our report dated 15 February 20X2. Our qualified audit opinion is based on the fact that the Company's inventories are carried in the [balance sheet][statement of financial position][3b] in those financial statements at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants. The Company's records indicate that had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively. Our qualified audit opinion states that, except for the effects of the described matter, those financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at 31 December 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]

Illustration 4:

Circumstances include the following:

- **An adverse opinion is expressed on the audited financial statements.**
- **Criteria are developed by management and adequately disclosed in Note X. The auditor has determined that the criteria are acceptable in the circumstances.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL STATEMENTS

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [Hong Kong] with limited liability)[5a]

The summary financial statements of ABC Limited ("the Company") set out on pages … to …, which comprise the summary [balance sheet][statement of financial position][5b] as at 31 December 20X1, the summary [income statement][statement of comprehensive income][5b], summary statement of changes in equity and summary [cash flow statement][statement of cash flows][5b] for the year then ended, and related notes, are derived from the audited financial statements of the Company for the year ended 31 December 20X1.[6]

The summary financial statements do not contain all the disclosures required by [describe financial reporting framework applied in the preparation of the audited financial statements of ABC Limited for example, the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants.] Reading the summary financial statements, therefore, is not a substitute for reading the audited financial statements of the Company.

Management's [7] Responsibility for the Summary Financial Statements

Management is responsible for the preparation of a summary of the audited financial statements on the basis described in Note X.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial statements based on our procedures, which were conducted in accordance with Hong Kong Standard on Auditing (HKSA) 810, "Engagements to Report on Summary Financial Statements" issued by the Hong Kong Institute of Certified Public Accountants.

Denial of Opinion

In our report dated 15 February 20X2, we expressed an adverse audit opinion on the financial statements of the Company for the year ended 31 December 20X1. The basis for our adverse audit opinion was [describe basis for adverse audit opinion]. Our adverse audit opinion stated that [describe adverse audit opinion].

5a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

5b Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

6 When the auditor's report on the summary financial statements is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial statements, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements."

7 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

Illustration 5:

Circumstances include the following:

- **An unmodified opinion is expressed on the audited financial statements.**
- **The summary financial report is prepared in accordance with section 141CF(1) of the Hong Kong Companies Ordinance and complies with the requirements of section 5 of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation.**
- **The auditor concludes that it is not possible to express an unmodified opinion on the summary financial statements.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [Hong Kong] with limited liability)[7a]

The summary financial report of ABC Limited ("the Company") set out on pages … to …, which comprises the summary [balance sheet][statement of financial position] [7b]as at 31 December 20X1[,][and] [7c] the summary [income statement][statement of comprehensive income][7b][, summary statement of changes in equity and summary [cash flow statement][statement of cash flows][7b]] for the year then ended, and related notes, are derived from the audited financial statements of the Company for the year ended 31 December 20X1. We expressed an unmodified audit opinion on those financial statements in our report dated 15 February 20X2.[8]

The summary financial report does not contain all the disclosures required by the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants. Reading the summary financial report, therefore, is not a substitute for reading the audited financial statements of the Company.

Directors' [9] Responsibility for the Summary Audited Financial Report

Under the Hong Kong Companies Ordinance, the directors are responsible for the preparation of a summary financial report in accordance with section 141CF(1) of the Hong Kong Companies Ordinance. In preparing the summary financial report, section 141CF(1) of the Hong Kong Companies Ordinance requires that the summary financial report be derived from the annual financial statements and the auditor's report thereon and the directors' report for the year ended 31 December

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[7a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[7b] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[7c] Section 5(3)(1) and (2) of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation states that a summary financial report of a listed company shall contain all the information and particulars included in the company's balance sheet and profit and loss account as they appear in the relevant documents; or the company's consolidated balance sheet and consolidated profit and loss account if the company is presenting group financial statements.

[8] When the auditor's report on the summary financial report is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial report, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements."

[9] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

<u>Illustration 6:</u>

Circumstances include the following:

- **A qualified opinion is expressed on the audited financial statements.**
- **The summary financial report is prepared in accordance with section 141CF(1) of the Hong Kong Companies Ordinance and complies with the requirements of section 5 of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation.**

REPORT OF THE INDEPENDENT AUDITOR ON THE SUMMARY FINANCIAL REPORT

TO THE SHAREHOLDERS OF ABC LIMITED

(incorporated in [Hong Kong] with limited liability)[10]

The summary financial report of ABC Limited ("the Company") set out on pages … to …, which comprises the summary [balance sheet][statement of financial position][11] as at 31 December 20X1[,][and][12]the summary [income statement][statement of comprehensive income][11][, summary statement of changes in equity and summary [cash flow statement][statement of cash flows][11]] for the year then ended, and related notes, are derived from the audited financial statements of the Company for the year ended 31 December 20X1. We expressed a qualified audit opinion on those financial statements in our report dated 15 February 20X2 (see below). A copy of the qualified auditor's report [and the further material necessary for the understanding of the qualification][13] [has/ have] been set out on pages … to … of the summary financial report.[14]

The summary financial report does not contain all the disclosures required by the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants. Reading the summary financial report, therefore, is not a substitute for reading the audited financial statements of the Company.

Directors'[15] Responsibility for the Summary Financial Report

Under the Hong Kong Companies Ordinance, the directors are responsible for the preparation of a summary financial report in accordance with section 141CF(1) of the Hong Kong Companies Ordinance. In preparing the summary financial report, section 141CF(1) of the Hong Kong

10 In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

11 Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

12 Section 5(3)(1) and (2) of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation stated that a summary financial report of a listed company shall contain all the information and particulars included in the company's balance sheet and profit and loss account as they appear in the relevant documents; or the company's consolidated balance sheet and consolidated profit and loss account if the company is presenting group financial statements.

13 Section 5(3)(c) of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation stated that a summary financial report of a listed company shall contain a statement from the company's auditors as to whether the auditors' report concerned is qualified or otherwise modified, and (if the auditors' report is qualified or otherwise modified) set out the full auditors' report and any further material necessary for the understanding of the qualification or other modification.

14 When the auditor's report on the summary financial report is dated later than the date of the auditor's report on the audited financial statements from which it is derived, the following sentence is added to this paragraph: "Those financial statements, and the summary financial report, do not reflect the effects of events that occurred subsequent to the date of our report on those financial statements."

15 Or other term that is appropriate in the context of the legal framework in the particular jurisdiction.

Companies Ordinance requires that the summary financial report be derived from the annual financial statements and the auditor's report thereon and the directors' report for the year ended 31 December 20X1, be in such form and contain such information and particulars as specified in section 5 of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation, and be approved by the board of directors.

Auditor's Responsibility

Our responsibility is to express an opinion on the summary financial report based on our procedures, which were conducted in accordance with Hong Kong Standard on Auditing (HKSA) 810, "Engagements to Report on Summary Financial Statements" issued by the Hong Kong Institute of Certified Public Accountants. We are also required to state whether the auditor's report on the annual financial statements for the year ended 31 December 20X1 is qualified or otherwise modified.

Opinion

In our opinion, the summary financial report on pages … to …:

a. is consistent with the annual financial statements and the auditor's report thereon and the directors' report of the Company for the year ended 31 December 20X1 from which it is derived; and

b. complies with the requirements of section 5 of the Hong Kong Companies (Summary Financial Reports of Listed Companies) Regulation.

However, the summary financial report is misstated to the equivalent extent as the audited financial statements of the Company for the year ended 31 December 20X1.

The misstatement of the audited financial statements is described in our qualified audit opinion in our report dated 15 February 20X2. Our qualified audit opinion is based on the fact that the Company's inventories are carried in the [balance sheet][statement of financial position][11] in those financial statements at xxx. The directors have not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants. The Company's records indicate that had the directors stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively. Our qualified audit opinion states that, except for the effects of the described matter, those financial statements give a true and fair view of the state of the Company's affairs as at 31 December 20X1, and of its [profit][loss] and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and have been properly prepared in accordance with [the Hong Kong Companies Ordinance][the disclosure requirements of the Hong Kong Companies Ordinance].

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor's address]

[Date of the auditor's report]