



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



Module Preparation Seminar (Part II)
for
Module C on Business Assurance

Speaker
Dr. Fiona Lam

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EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD



About the Lecturer



Dr Fiona Lam

Managing Director and Principal Lecturer - MC & MD

*PhD, ACA(UK), FCCA, FAIA,
CPA(Practising), BBA(Acc & Fin), ATIHK*

- ❖ Practising partner of a medium size firm
- ❖ Practical experience in corporate governance, risk management, auditing and tax
- ❖ Passed QP exams and other exams ie ACCA, AIA, PC all in one go
- ❖ Professional training 10 years ago and has been teaching MC & MD since then
- ❖ Taught over 5000 students



Module Preparation Seminar on Major or Difficult Syllabus Topics (Part II)

- Responses to assessed risks (HKSA 330 (Clarified))
- Corporate governance practice
- Audit materiality (HKSA 320 (Clarified))



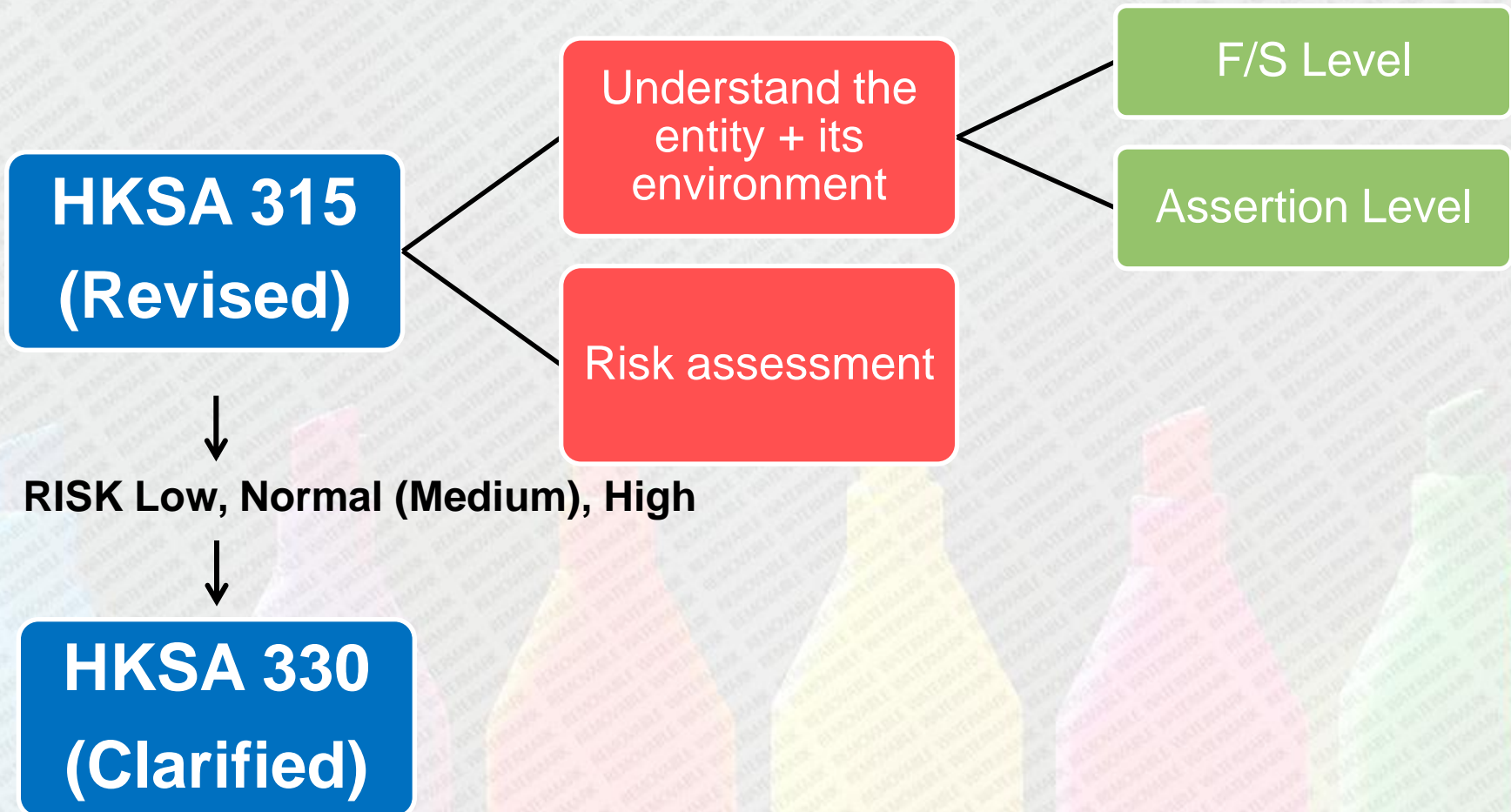
HKSA 330 (Clarified)

Responses to assessed risks

MC – Responses to assessed risk



HKSA 315 (Revised) + HKSA 330 (Clarified)



MC – Responses to assessed risk



Audit Risks

Risks of Material Misstatement

Detection Risks

At Financial Statement Level

At Assertion Level

Inherent Risks

Control Risks

Auditors perform risk assessment procedures to understand the entity and its environment and then assess the risks (Chapter 8)

Perform procedures in response to assessed risks to reduce audit risks to an acceptably low level (See Chapters 9, 10, 11, 12, and 13)

MC – Responses to assessed risk



For Financial Statement Level

- Remind the engagement team to maintain professional skepticism
- Assign more experienced staff
- Budget more review and supervision
- Assign an expert if required, for example if computer fraud is suspected
- Do not rely on entity's internal control and use substantive procedures only
- Perform audit procedures in unexpected manner
- Consider resignation from engagement
- Collect more pervasive evidence
- Making general changes to the nature, timing or extent of audit procedures

MC – Responses to assessed risk



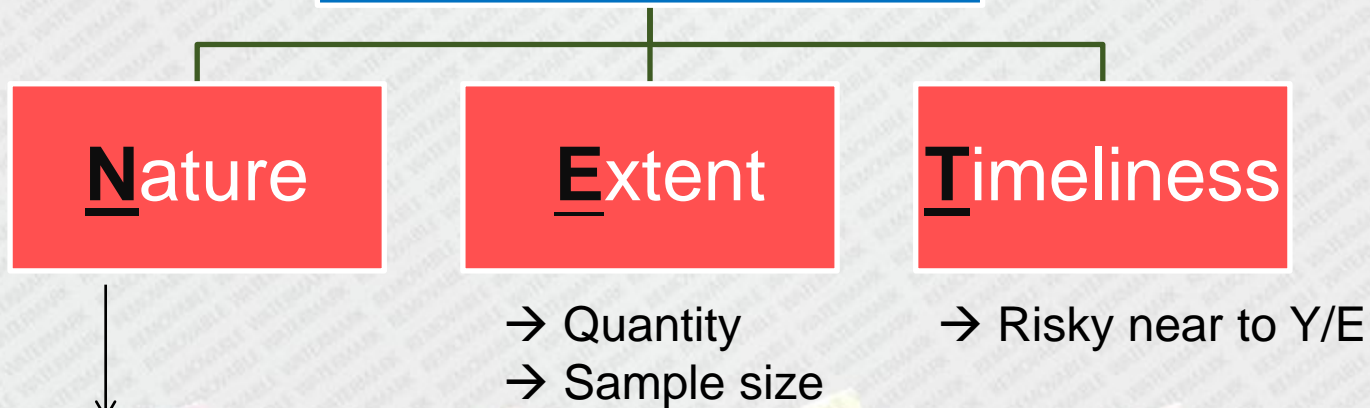
For Assertion Level

The HKSA 330 (Clarified) says that the auditor shall design and perform appropriate audit procedures whose **nature, extent and timing** are based on and are responsive to the assessed risks of material misstatement at the assertion level.

MC – Responses to assessed risk



Audit Procedures



Audit Approach

- **Combined** Approach
→ TOC & Sub Testing: IC strong
- **Substantive** Approach
→ Substantive Testing only: IC weak

MUST perform some Substantive Testing

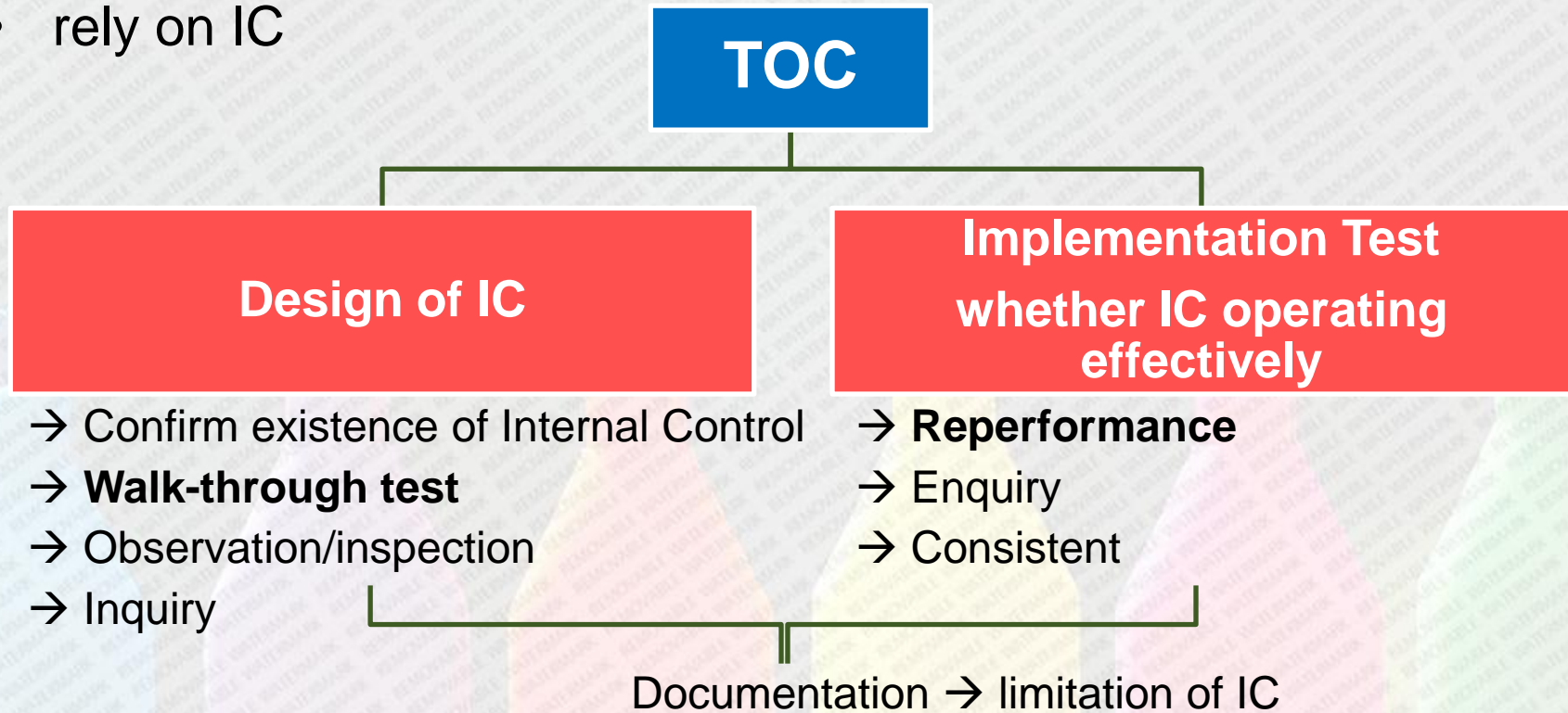
MC – Responses to assessed risk



HKSA 330 (Clarified) Tests of Controls

Purpose:

- reduce Substantive Testing
- rely on IC



MC – Responses to assessed risk



HKSA 330 (Clarified) Tests of Controls

WHEN to perform IC → TOC

Expect IC working effectively

- control risk
→ low
- rely on IC
→ decrease Substantive Testing

E-business

- Substantive Testing cannot satisfy sufficient and appropriate audit evidence
→ TOC

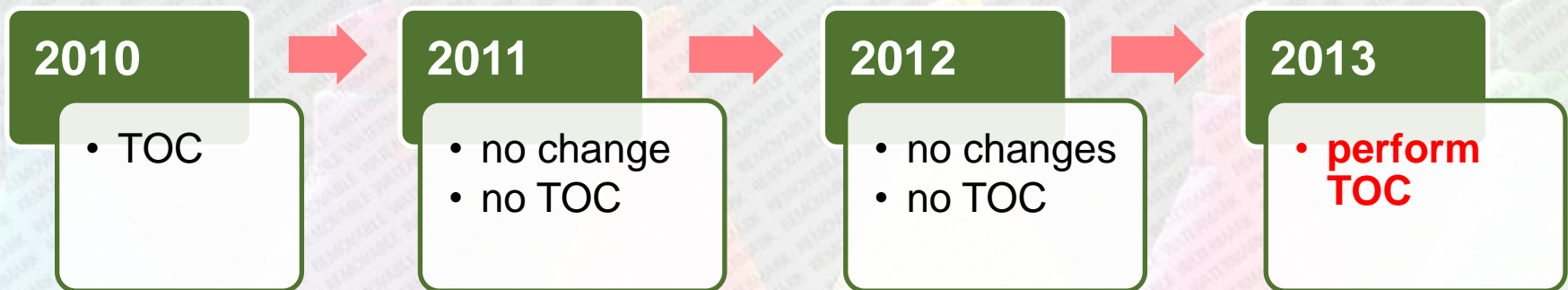
MC – Responses to assessed risk



HKSA 330 (Clarified) Tests of Controls

Rely on TOC from prior year

- **Change** as from last tested
- TOC must be performed **every 3 years** even without changes



MC – Responses to assessed risk



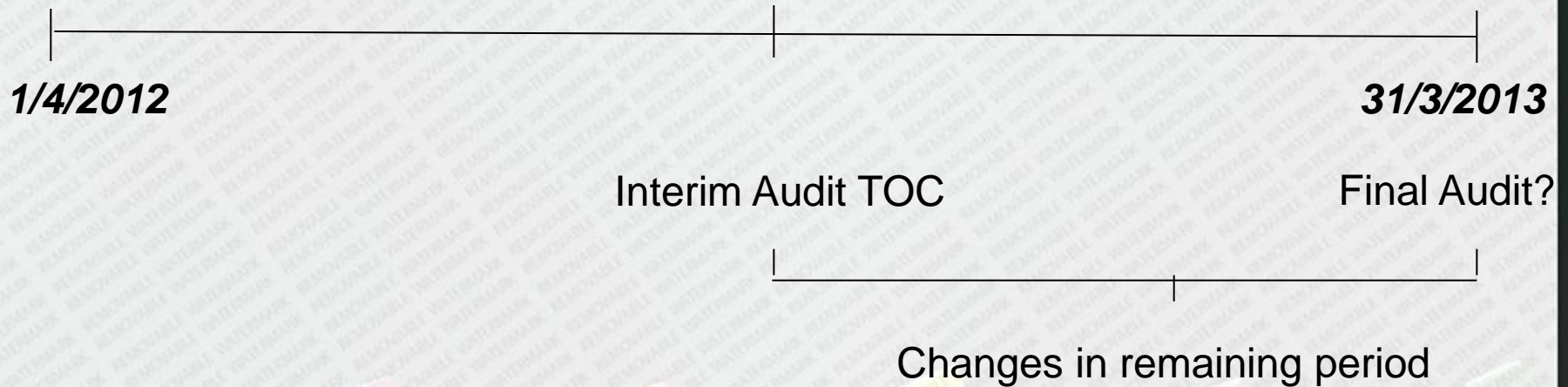
HKSA 330 (Clarified) Tests of Controls

The auditor shall also undertake tests of controls when it will not be possible to obtain sufficient appropriate audit evidence **simply from substantive procedures alone**. This might be the case if the entity conducts its business using IT systems which do not produce documentation of transactions.

MC – Responses to assessed risk



HKSA 330 (Clarified) Tests of Controls



IC to mitigate **significant risks**

→ Auditor must test every year even without changes

MC – Responses to assessed risk



HKSA 330 (Clarified) Substantive Testing

Substantive Procedures (HKSA 330 (Clarified))

obtain sufficient & appropriate Audit Evidence

detect Material Misstatements

WHEN:

- CR high ; IC weak → Substantive Testing ↑
- reduce Detection Risk

MC – Responses to assessed risk



HKSA 330 (Clarified) Substantive Testing

Substantive Testing

Substantive Analytical Procedures

- large volume of immaterial balances
- IC strong
- expectation of less immaterial errors

Tests of Details

- vouching
- confirmation
- tracing
- observation
- specifically responsive to that risk
- appropriate with regard to matters which have been identified as **significant risks**

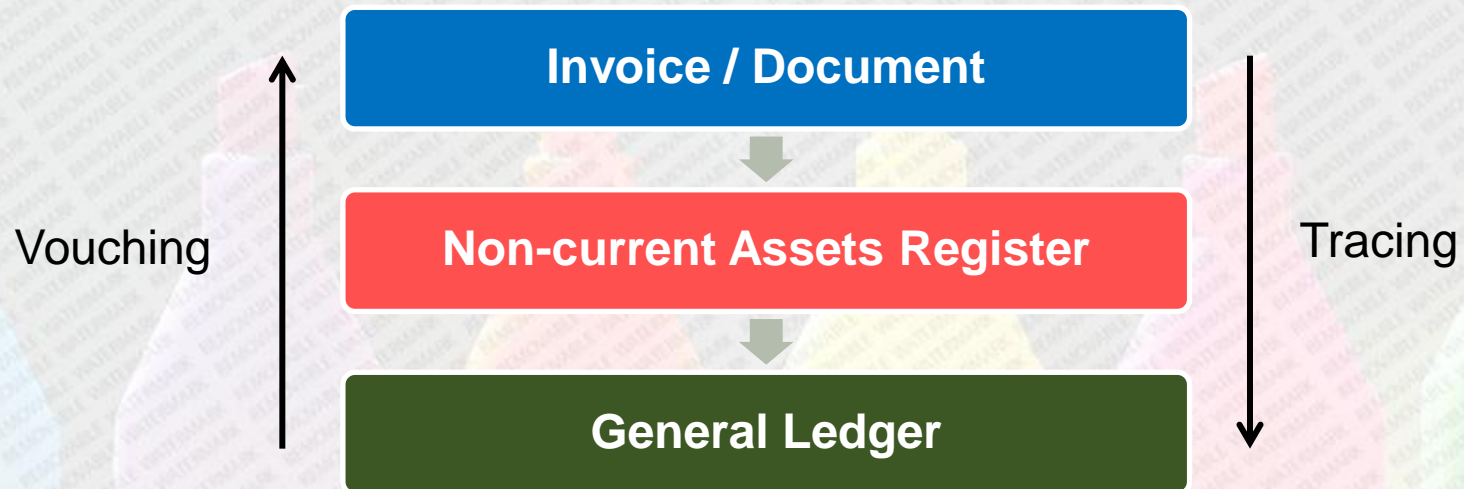
MC – Responses to assessed risk



Specific Audit Procedures

Statement of Financial Position

- Non-current Assets → Fixed Assets
- Property → HKAS 16 *PPE* ; HKAS 40 *Investment Property*
- Plant & Equipment / Computer / MV



MC – Responses to assessed risk



Specific Audit Procedures

For example : Existence

PPE exist properly recorded at Y/E

- Existence
- PPE recorded in non-current assets register actually exist at Y/E
- Physical inspection
- Confirmation
- Vouch to invoice
- Trace invoice to non-current asset register

MC – Responses to assessed risk



Audit Procedures

For example : Completeness: records complete

Bal b/f	xxx	→ Check opening balance
Additions	xxx	→ Check authorization
Disposals	<u>(xxx)</u>	→ BOD minutes, sales & purchase agreements
Bal c/f	xxx	

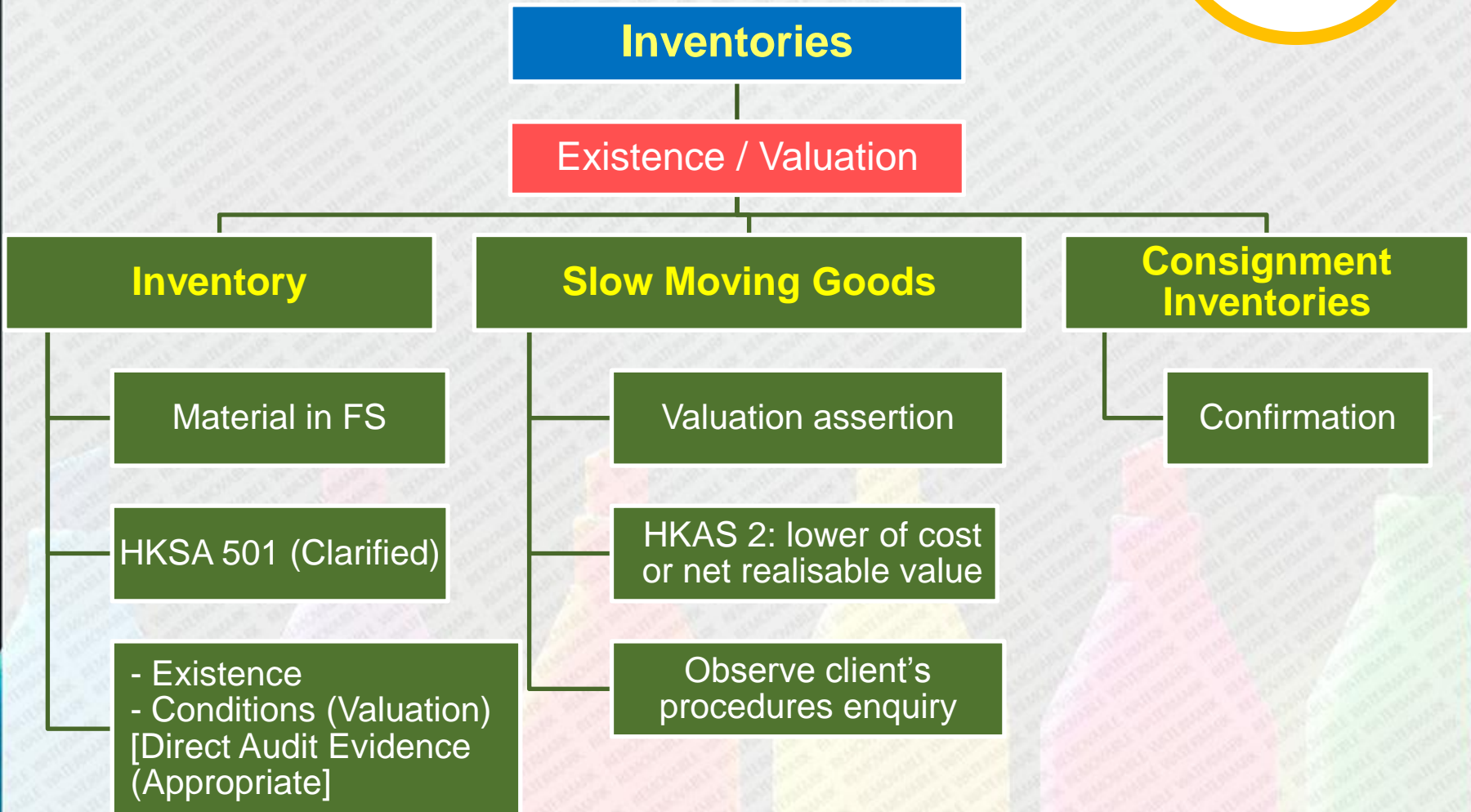
PPE exist property recorded at Y/E

- recalculate P&L on disposal
- check subsequent events
- check cutoff
- perform land search
- vouch to invoice

MC – Responses to assessed risk



Audit Procedures



MC – Responses to assessed risk



Audit Procedures

Accounts Receivable [Debtors]

- Directional Testing → double entry: **(Dr) Trade Debtor**
(Cr) Sales

HKSA 505 (Clarified) External Confirmation → Direct Communication to External Party

- **“appropriate”** audit evidence → reliable
- immediately after Y/E
- **maintain control by auditors**
- ie Independent Selection:
Debtor → directly reply to auditor

overstate Revenue
→ **overstate Trade Debtors**

Alternative Procedures

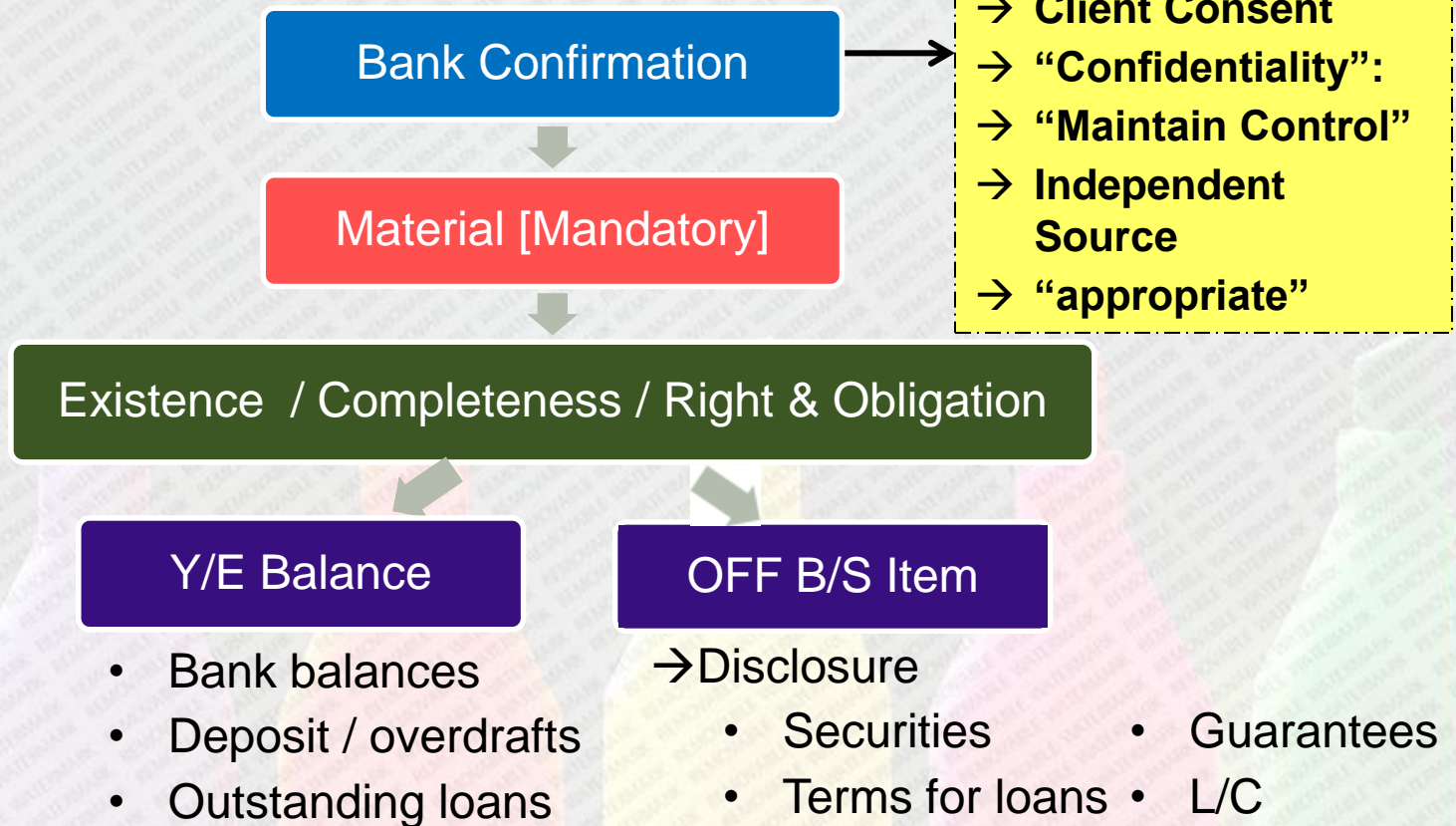
- Subsequent Settlement
- Enquiry / Reconciliation

MC – Responses to assessed risk



Audit Procedures

Bank & Cash [Cash and Cash Equivalents]



HKSA 505 (Clarified)

- Client Consent
- “Confidentiality”:
- “Maintain Control”
- Independent Source
- “appropriate”

MC – Responses to assessed risk



Audit Procedures

Sales [Revenue]

Large volume of transactions



Material



(1) Substantive Analytical Procedures



- Compare with last year %↑ risk ↑
- Ratio Gross Profit Margin [Turnover convert into profits]
- Compare Trade Receivable [Liquidity Position]
- Compare to Inventory [ability to sell existing inventories]

MC – Responses to assessed risk



Audit Procedures

Sales [Revenue]

Large volume of transactions



Material



(2) Tests of Details



- **Occurrence:** vouch to sales invoice / order
- **Completeness:** tracing dispatch notes to sales ledger
- **Accuracy:** Sales Recognition Policy
- **Cutoff:** Cutoff Procedures
- **Accuracy Presentation:** discounts



Exam Questions Review

Dec 2011 – Qu 7

Audit Procedures

MC – Exam Questions Review



[Audit Procedures]
Dec 2011 – Qu 7

Question

You are the auditor of CC Limited (CC). CC acquired DD Limited during the year and recorded **goodwill** of HK\$300 million and intangible assets such as trademark, patent and customers relationship of HK\$500 million. Management of CC engaged X Limited to value the intangible assets and advise on the business valuation of the transaction. Based on the business valuation performed by X Limited, CC developed its **goodwill impairment** assessment and concluded that no goodwill impairment is necessary.

MC – Exam Questions Review



[Audit Procedures] Dec 2011 – Qu 7

Question

- a) Evaluate and explain **the risk of material misstatement** relating to the **valuation assertion** of CC Limited's goodwill and **intangible assets** as at 31 December 2011. (4 marks)
- b) Suggest and discuss the **audit procedures** you would perform **on goodwill and intangible assets** respectively in response to the assessed risk of material misstatement in (a). (9 marks)

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[Audit Procedures] Dec 2011 – Answer 7(a)

HKSA 315 (Revised) : The valuation of goodwill and intangible assets may be materially misstated if:

- Using **wrong assumptions**, business data and valuation methodology used;
- Certain intangible assets are **not identified** from the acquisition;
- **Useful life** of the intangible assets are over-estimated; and
- Goodwill impairment assessment **not properly prepared**; using inappropriate business data and assumptions.

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[Audit Procedures] Dec 2011 – Answer 7(b)

Think about the accounting treatment of goodwill

Purchase consideration

Less : Net asset value of the shares purchased (Fair Value)

= Goodwill

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[Audit Procedures]

Dec 2011 – Answer 7(b) (Cont'd)

Audit procedures on goodwill:

- Inspect the **selling and purchase agreement** and agree the consideration to the selling and purchase agreement;
- Assess the reasonableness of the business valuation performed by X Limited by reviewing the **valuation methodology, data and assumptions used**;
- Assess the **competence, objectivity and independence of X Limited** to ensure X Limited has the expertise on advising the business valuation and intangible assets; **(HKSA 620 (Clarified))**

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[Audit Procedures]

Dec 2011 – Answer 7(b) (Cont'd)

- **Recalculate** the purchase price allocation among assets acquired and liabilities assumed, intangible assets identified and goodwill allocated;
- Check **purchased goodwill** is calculated correctly which should reflect the **difference between the fair value of the consideration given** and the aggregated of the fair values of the separable net assets acquired; and
- Review the **goodwill impairment assessment** performed by CC Limited. Discuss with management the **reasonableness of assumptions and data used** and appropriateness of the assessment model.

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[Audit Procedures]

Dec 2011 – Answer 7(b) (Cont'd)

Audit procedures on purchased **intangible assets**:

- Inspect the **selling and purchase agreement** and agree purchased intangibles as to the selling and purchase agreement;
- Inspect the **valuation report** prepared by X Limited to ensure the valuations of the intangibles are reasonable;
- Assess the **reasonableness of the useful life** of the intangible asset estimated by X Limited and management; and
- Recalculate the **amortisation** calculations of the intangibles prepared by management. **(HKSA 540 (Clarified))**



Exam Questions Review

Feb 2008 – Qu 6

Audit Procedures

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**[Audit Procedures]
Feb 2008 – Qu 6**

Question

Many trading, wholesaling, and manufacturing companies have material trade receivable balances. Trade receivable is usually classified as “loans and receivables” under HKAS 39 “Financial Instrument: Recognition and Measurement” with initial measurement at fair value plus transactions costs and subsequent measurement at amortised cost.

Comment on the matters to be considered by the independent auditors in evaluating the **adequacy of the impairment loss** on bad and doubtful accounts of trade receivable.

(13 marks)

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[Audit Procedures]

Feb 2008 – Answer 6 (Cont'd)

The carrying amount of net trade receivable equals the gross trade receivable minus the **related impairment loss on bad and doubtful accounts**.

Evaluating the adequacy of the impairment loss on bad and doubtful debts.

- understand, ascertain and evaluate the **effectiveness of the internal controls** over credit policy and control.
- understand and ascertain the **aging** of the trade receivable balances.

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[Audit Procedures] Feb 2008 – Answer 6 (Cont'd)

Different industries may have different credit periods. If the trade receivable balance **does not exceed the credit limit** and is still within the company's credit period, the balance is unlikely to have an impairment problem. For those **over the credit limit**, consider the impairment loss.

Perform analytical procedures, such as comparing the trade receivable turnover with previous years', similar companies or the industry average. **Investigate outstanding trade receivable balances**, especially for unusual and/or material amounts, and obtain satisfactory explanation from the audit client and **related party transactions**

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[Audit Procedures] Feb 2008 – Answer 6 (Cont'd)

Subsequent cash receipts from the customers show that the pertinent trade receivable balance does not have any collection problems.

Review the audit client's **follow-up action** on long-outstanding trade receivable balances such as :

- Ascertain the **realisation of collateral** and securities pledged
- Review reports from credit and **collection agencies**;
- Review the status of **any legal action** taken, such as legal letters, claims through lawyers, ie Small Claims Tribunal and court actions, liquidation or bankruptcy, etc.

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[Audit Procedures]

Feb 2008 – Answer 6 (Cont'd)

- Consider any **set-off arrangement** with the customers in respect of current accounts and reciprocal sales and purchases.
- **Review correspondence with customers** and note any complaints or dispute in respect of, say, sub-standard, non-delivery, damage, and incorrect delivery.

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[Audit Procedures]

Feb 2008 – Answer 6 (Cont'd)

- **Review the audit client's assessment** of the impairment of trade receivable balances
- **Ascertain and review the audit client's assessment policy and procedures**, and obtain the schedule on individual assessment, collective assessment, impairment loss and reversal of impairment loss.

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[Audit Procedures]

Feb 2008 – Answer 6 (Cont'd)

HKSA 540 (Clarified), Auditing the **accounting estimate** of the impairment or bad debt loss on trade receivable:

1. Review and test **the process used by management** to develop the estimate;
2. Use an **independent estimate** for comparison with that prepared by management; or
3. Review **subsequent events** which provide audit evidence of the reasonableness of the estimate made.



Exam Questions Review

Jun 2011– Qu 6

Audit Procedures

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[Audit Procedures] Jun 2011 – Qu 6

Question

C Limited is a customer of X Limited. In X Limited's accounting records, HK\$2,589,000 is shown as an outstanding balance receivable from C Limited as at 30 June 2010. C Limited and X Limited have recently been disputing over the quality of some products delivered from X Limited to C Limited.

You are the auditor of X Limited. Explain how you would evaluate the **valuation and allocation assertion of the overall trade receivables balance**, in which HK\$2,589,000 due from C Limited is under dispute, in X Limited's accounting records.

(12 marks)

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[Audit Procedures] Jun 2011 – Answer 6

The amount shown in X Limited's trade receivables should be the **outstanding amount on trade receivables less impairment loss for irrecoverable debt.**

Audit procedures on **sales and trade receivables** are usually combined due to the inter-relationship between the two items in accounting procedures and **internal control systems.**

X Limited's auditor should **understand and evaluate the major activities** that X Limited uses to **monitor internal control**

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[Audit Procedures] Jun 2011 – Answer 6 (Cont'd)

These accounting procedures and **internal controls** should cover:

- **billing procedures and recordings** of sales and receivables;
- quality assurance / control procedures over products before and after delivery;
- **credit policies** and controls;
- collection of trade receivables; and
- procedures adopted by X Limited's management in the identification and estimate of impairment loss for irrecoverable debt.

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[Audit Procedures] Jun 2011 – Answer 6 (Cont'd)

X Limited's auditor should carry out some of the following **substantive procedures**:

- send a **confirmation** to C Limited and other debtors;
- **compare** the balance to the relevant turnover and previous months / years;
- **compare** the aged analysis to other debtors and previous months / years;
- **discuss** with management (and X Limited's lawyer) the nature and status of the dispute;

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[Audit Procedures]

Jun 2011 – Answer 6 (Cont'd)

- **discuss with management** (and X Limited's lawyer) the recoverability of the entire balance HK\$2,589,000;
- discuss with management the implications (if any) of C Limited's claims (product quality) on other debtors or accounts;
- check for any **subsequent settlement** from C Limited and other long outstanding debtors; and
- **check for any returns of goods** from C Limited and other customers.



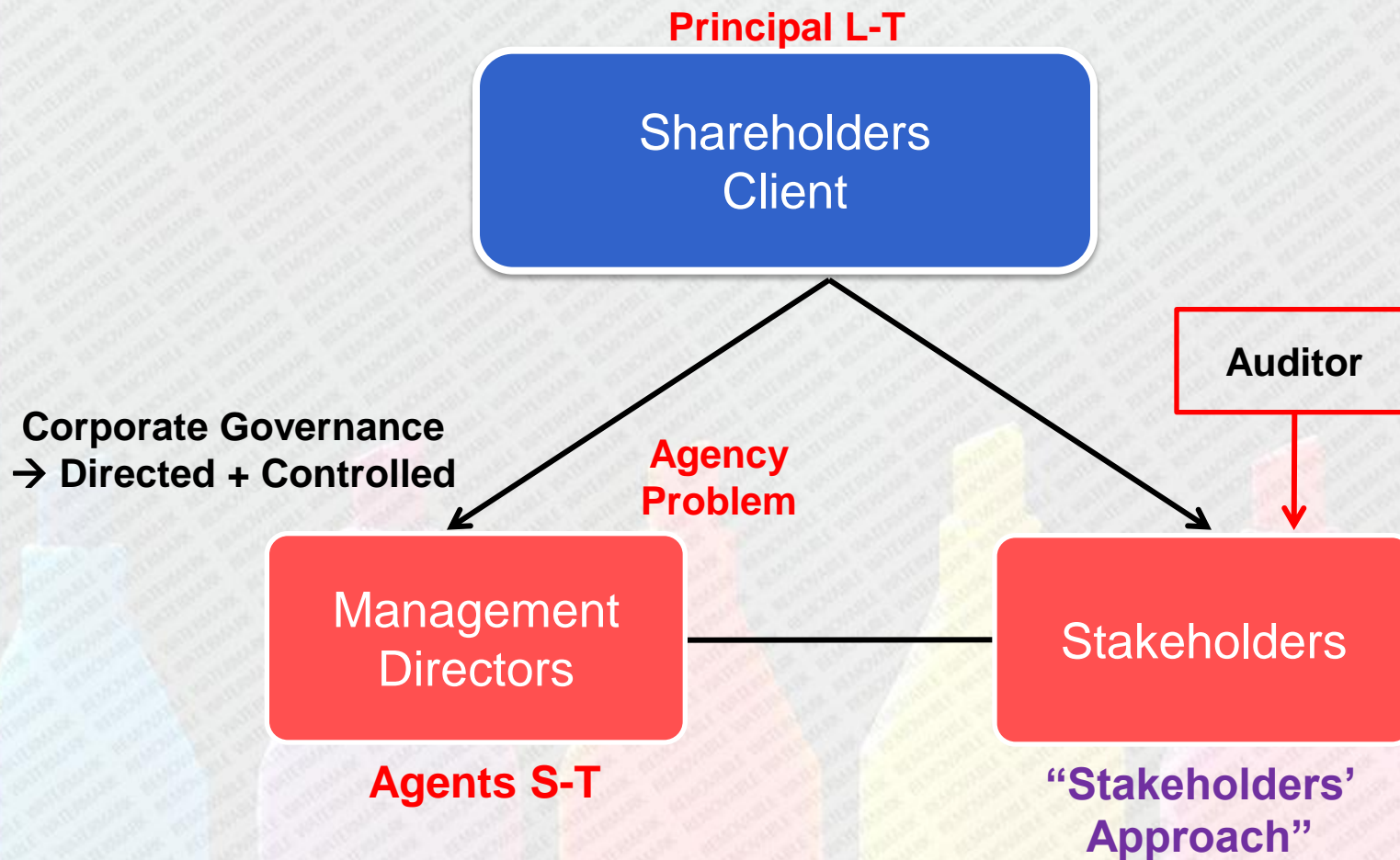
Corporate governance practice

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Why Corporate Governance?



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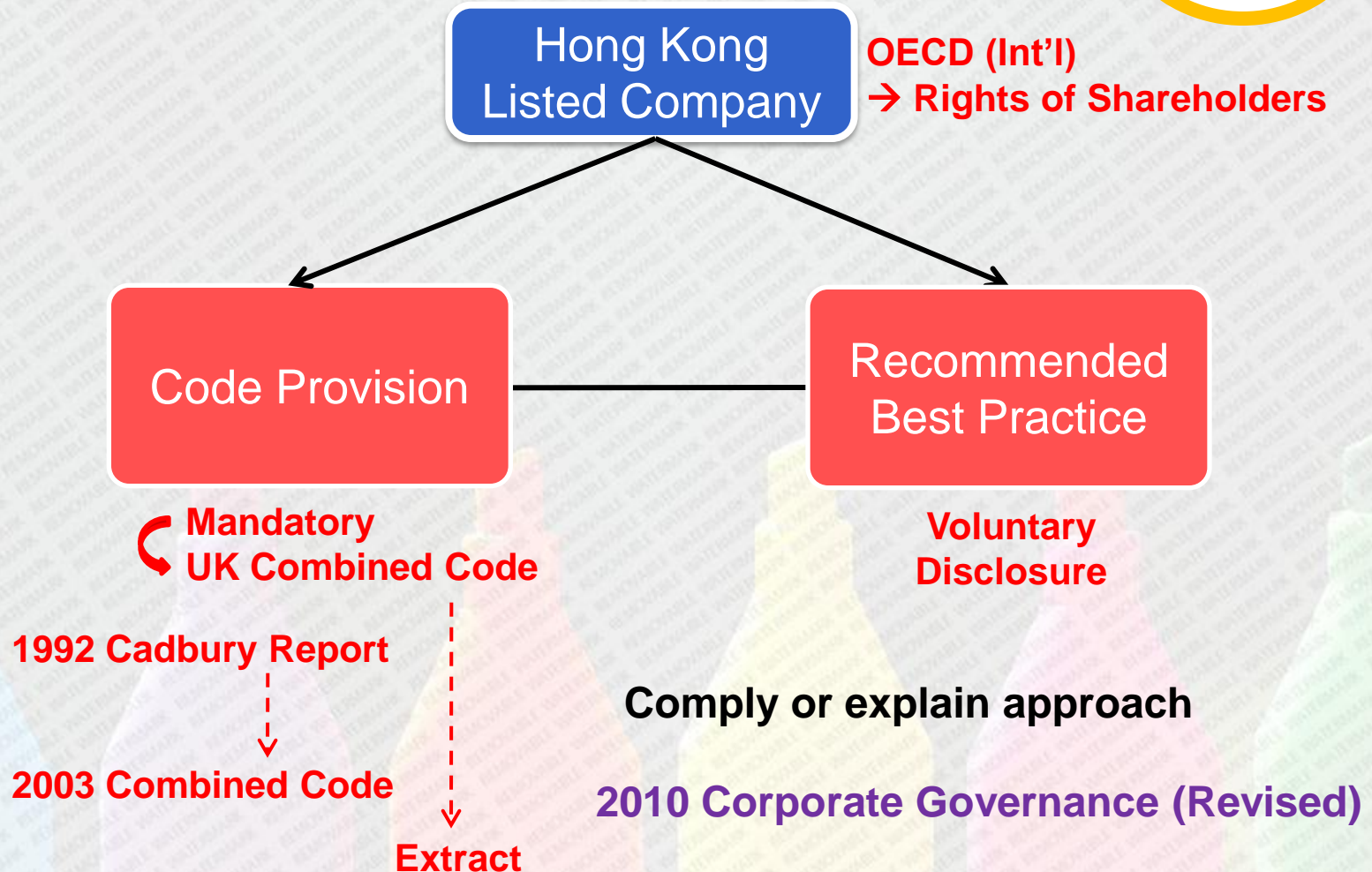
Major Concepts of Corporate Governance

- Ethics → Business ethics
- Transparency → Annual report
→ Attract shareholders
- Safeguard assets → Fraud
- Comply with laws + Regulations → Listing rules
- Strong internal control + Risk management
- International investors → Pay premium
- Enhance shareholders' value

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Hong Kong Listed Companies



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Exam Technique

1. Criticize Problem

2. Recommendations

3. Follow Listing Rules

Company with Problems



Corporate Governance Concepts I

- **The Board** – effective board / **active interest in the issuer's affairs**
- **Chairman and Chief Executive Officer** – separated a clear division of these responsibilities at the board level.
- **Board composition** – balance of skills and experience appropriate; The new Rule required that at least **one-third** of an issuer's board should be **independent non-executive directors (INEDs)**.
- **Appointments, re-election and removal** – formal, considered and transparent procedure for the appointment of new directors to the board.
- **List of directors should be published on the issuer's website**



Corporate Governance Concepts II

- **An INED who has served nine years**
- **Separate resolution to retain an INED who has served on the board for more than nine years.**
- **Directors should provide records of training they received to issuers.**
- **Board should regularly review the contribution by a director.**
- **Supply of and access to information** – Directors should be provided in a timely manner with appropriate information.
- **The board should be responsible for corporate governance.**
- **Non-executive directors, including INEDs, should attend board, committee and general meetings and contribute to the issuer's strategy and policies.**



Corporate Governance Concepts III

- **Directors – Remuneration of directors and senior management and Board Evaluation**
- Disclose information relating to its **directors' remuneration policy** and other remuneration related matters. (Disclosed in full in the annual reports and Accounts)
- The company should establish a **remuneration committee**
- **Formal and transparent procedure** for setting policy on executive directors' remuneration



Corporate Governance Concepts III (Cont'd)

- Fixing the **remuneration packages** for all directors
- A significant proportion of executive directors' remuneration should be structured so as to **link rewards** to corporate and individual performance.
- Directors' fees and any other **reimbursement or emolument payable to a director must be disclosed in full in the annual reports and accounts** of the issuer on an individual and named basis.



Corporate Governance Concepts IV

- **Audit Committee** – The board should establish **formal and transparent arrangements** for considering how it will apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.
- Listed company should establish a **shareholder communication policy**.
- **Company Secretary**
 - The Company Secretary supports the Chairman in **promoting** the highest standards of corporate governance.
 - **Ensuring good information flow** within the board and that board policy and procedures are followed.
 - The Company Secretary **reports to the Chairman**



Corporate Governance Concepts V

- **Auditor attending the AGM**
- The management of a company should ensure the **company's auditor attends the annual general meeting ("AGM")** to answer questions relevant to:
 - the conduct of the audit – responses to questions about the **conduct of the audit**
 - the **preparation and content of the auditor's report;**
 - the **accounting policies** adopted by the company in relation to the preparation of the financial statements; and
 - the **independence** of the auditor in relation to the conduct of the audit.
- **Modification** to the independent auditor's report, if any

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Development in Corporate Governance

On 7 September 2012, Hong Kong Exchanges and Clearing Limited (HKEx) published its "Consultation Paper - **Board Diversity**" (Consultation Paper) to set out the proposed amendments about board diversity to Appendix 14 (Corporate Governance Code (Code) and Corporate Governance Report) to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

The major purposes of the proposed amendments are to **promote effective decision-making and better governance and monitoring through diversity in the boardroom**. It is proposed that diversity will be given a wide interpretation and no criteria will be prescribed to define its meaning. An issuer should take into account various factors to achieve boardroom diversity depending on its own business model and circumstances, including **gender, age, cultural and educational background and professional experience**.

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Agency Problem

Agency Costs to monitor the directors:

- Audit fee
- Internal auditors
- Experts

**Shareholders
(Principals)**

Dividend and capital gain

Agency Problem

→ Solve:

Alignment of interests: Share options/ profits related pay

Directors' remuneration package:

- Retain and attract directors

Package:

- Salary + ST & LT bonus
- Benefits in kind + Share options

Directors

Accountability

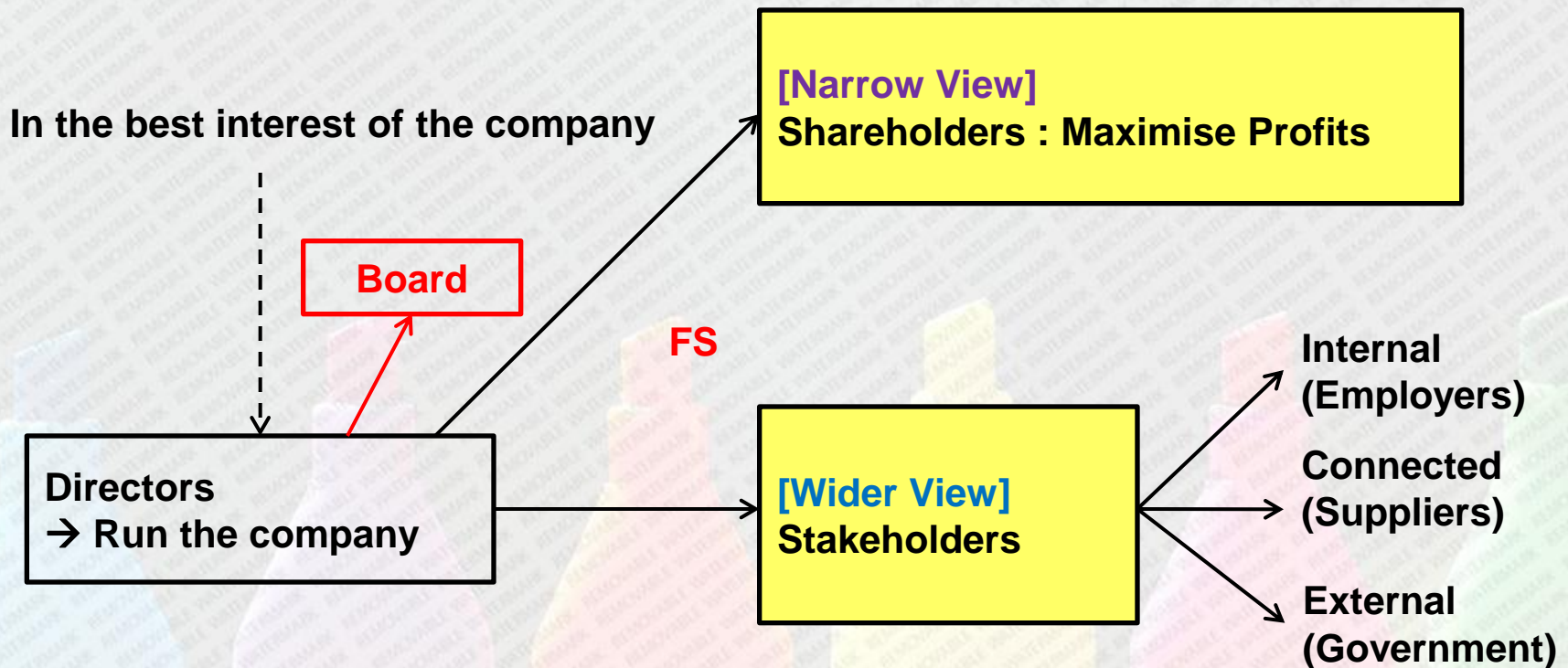
Fiduciary duties

Statutory duties

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Stakeholders – Narrow View Vs Wider View



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Open Question –

Does the Company need to adopt stakeholder's approach?

Yes

- Trend → Globally
- Corporate social responsibility
- Attract shareholders
- Increasing internationalization
- Avoid corporate scandals

No

- Too wide
- Too costly to suit everyone
- No legitimate effects – ie no economic benefits
- Culture differences

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Principles-based Vs Rules-based System

✓ **Principles-based system** → Comply or Explain Approach

Non-Compliance : disclose in annual report

**Cadbury Report
(1992)**



**Combined Code
(2010)**



✓ **Rules-based system** → US (SOX)
→ based on Legal / Legislations

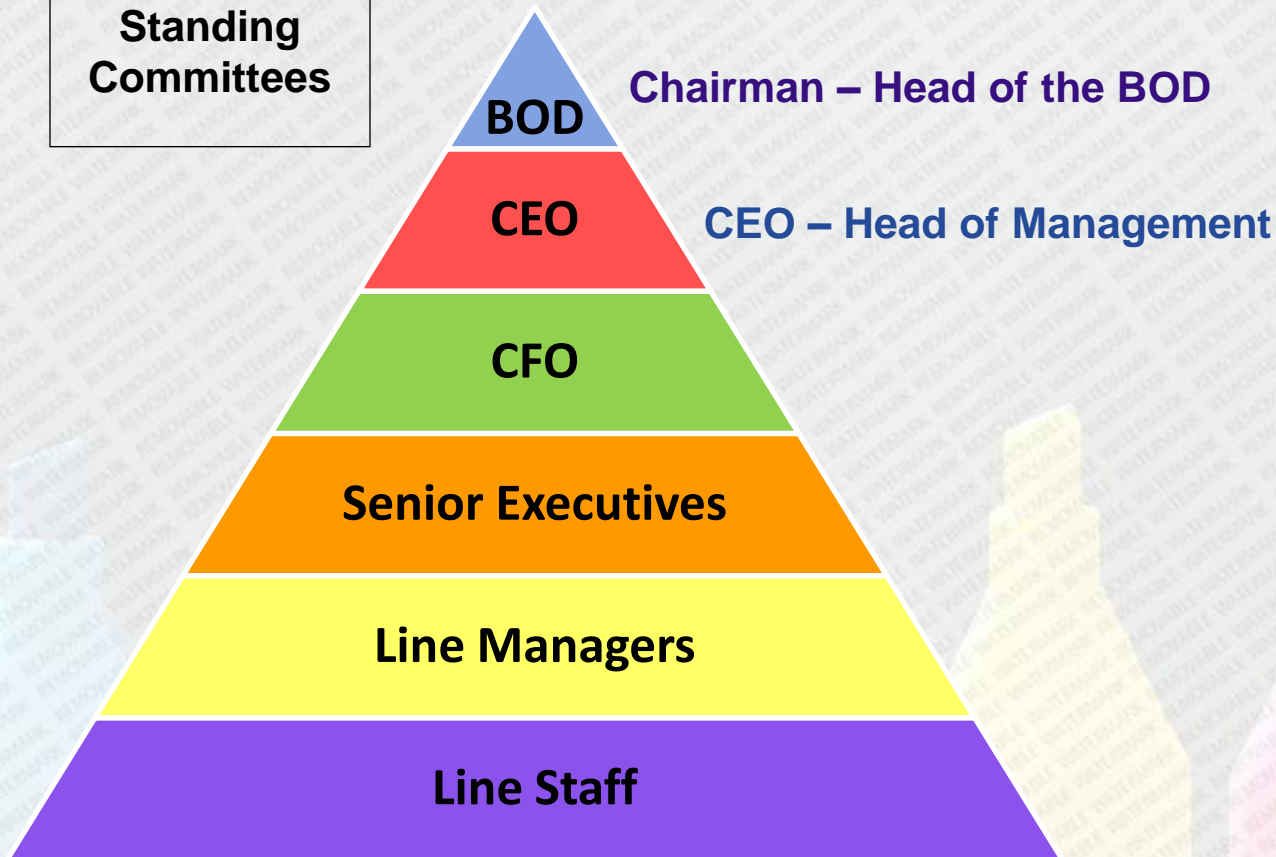
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Chairman Vs CEO

“Chairman ≠ CEO”

Standing
Committees



**Management
Operations**

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Standing Committees

Nomination Committee

- NEDs
- Nominate directors
- Recommendation to BOD

Remuneration Committee

- NEDs
- Remuneration policy
- Remuneration procedures

Audit Committee

- NEDs
- Deal with external auditors
- Formal transparent appointment of auditors

Risk Committee

- EDs and NEDs
- Risk policies
- Risk responses



Adopt Stakeholders' Approach

- Identify Stakeholders
- Stakeholders' Consequences / Reactions
→ Agree / Disagree

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The Board

EDs

- Implement strategies
- Setting strategies
- Implementing internal controls
- Monitor controls

NEDs

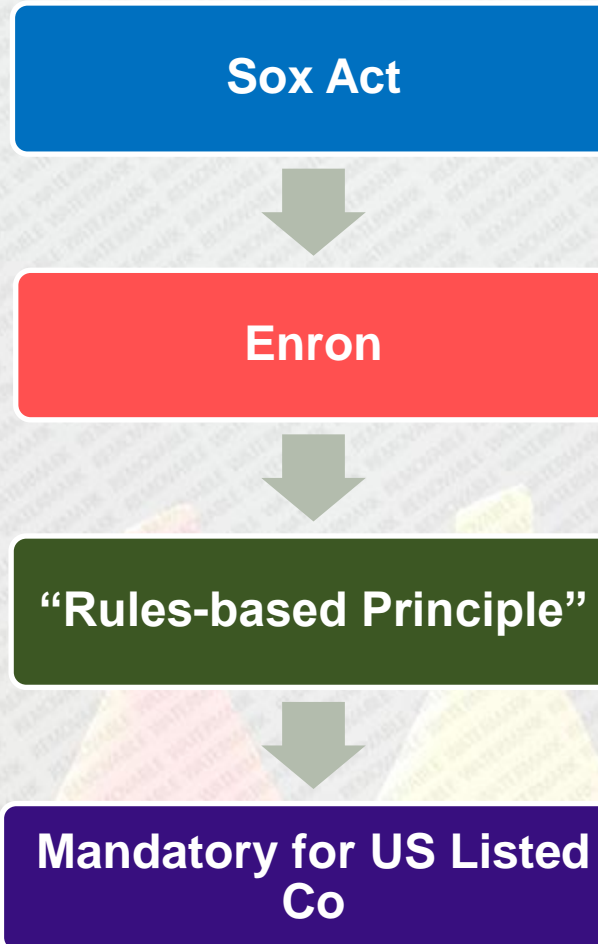
- Review / Monitor / Recommendation to BOD
 - Board Committee
-
- Nomination
 - Remuneration
 - Audit
 - Risk
 - Fixed fee
 - No performance related pay
ie bonus or share options

NEDs

MC – Responses to assessed risk



Sarbanes - Oxley Act 2002





Major Concepts in SOX

- New Regulator → Public Oversight Board (PCAOB)
- Regulate Audit Firms
 - Retain working papers 7 years
 - Prohibit other non audit services
 - Rotate Partner every 5 years
 - Audit Committee **(MUST)**
- CEO + CFO – certify FS – forfeit their bonuses
- Disclose off-balance sheet item
- Adequate IC reporting
- Whistle blowing act

MC – Corporate governance practice



Realistic Situation

Rules-based System
Consolidation (SOX)

US Holding Co.



Principle-based System

HK Sub

London / HK / Tokyo

Insufficient BOD members

- Training Costs
- Compliance Costs
- Documentation ↑
- Legal Experts

Impact of SOX:

**More listing in principle-based
jurisdictions
ie HK / London/ Tokyo**



Exam Questions Review

Jun 2012 – Case Qu 4

Corporate Governance

Practice

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[Corporate Governance Practice] Jun 2012 – Case Qu 4 (Extracted)

Question

Super Energy Limited (“Super Energy”) is a global oil company listed in Hong Kong. It has operations in over 50 countries and is one of the largest energy companies in the world. It produces around the equivalent of 2 million barrels of oil per day and has over 10,000 petrol service stations worldwide.

MC – Exam Questions Review



[Corporate Governance Practice] Jun 2012 – Case Qu 4 (Extracted)

In June 2011, because of a gas release, Super Energy's oil rig working on the Bargara exploration well in the Gulf of Sankala exploded. The fire burned for 48 hours before the rig sank and the oil leaked into the Gulf of Sankala for 85 days before the well was closed and sealed. Ten people died in the accident and others were injured. The accident also caused significant damage to the environment and the livelihoods of those in the communities nearby. The accident was widely reported by the media. Super Energy was requested by the US government to investigate and explain the causes of the accident to the public.

MC – Exam Questions Review



[Corporate Governance Practice] Jun 2012 – Case Qu 4 (Extracted)

4) According to the Code on Corporate Governance Practices in Hong Kong and in response to the accident in the Gulf of Sankala, discuss how the following stakeholders could discharge or perform better their own functional duties and related corporate governance responsibilities towards financial reporting and internal controls:

- a) The board of directors (6 marks)
- b) Audit Committee (4 marks)
- c) ABC & Co. (4 marks)

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[Corporate Governance Practice] Jun 2012 – Case Answer 4a

The board of directors of Super Energy have direct corporate governance responsibility for the accident and should:

Perform and present a balanced, clear and comprehensive assessment of the impact of the accident on Super Energy's current year performance, balance sheet position and future prospects to both the shareholders and investors.

Ensure maintenance of proper records for providing reliable financial, managerial and operating information for decision-making, evaluation of activities or publications relating to the accident.

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[Corporate Governance Practice] Jun 2012 – Case Answer 4a (Cont'd)

Ensure adequate control of the risks inherent in the rig operations, investigate the causes of the accident, act on the lessons learnt and improve the operation safety manual if necessary.

Understand the impacts and implications of the accident and take appropriate actions to clean up the environment and provide appropriate compensation to those affected.

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[Corporate Governance Practice] Jun 2012 – Case Answer 4b

The **Audit Committee** has the responsibility of liaising with ABC & Co., supervising internal audits and reviewing the annual financial statements and internal controls. In response to the accident, the Audit Committee should:

- **Discuss with the board of directors** the setting up of an independent committee to investigate the causes of the accident.
- **Set up and supervise an independent team** to understand the root cause of the accident.
- Supervise the **Internal Audit** to review the operational procedures, identify control deficiencies and any improvement on operation procedures as required.
- **Discuss with the board of directors and / or external advisors** the procedures setting up for claims from those affected.
- **Discuss with legal, finance and accounting departments** / units and the Internal Audit the adequacy of provision and contingency made against the accident and the sufficiency of disclosures made in the quarterly and annual reports.

MC – Exam Questions Review



[Corporate Governance Practice] Jun 2012 – Case Answer 4c

ABC & Co. **does not have direct corporate governance** responsibility for the accident, but they are required to provide a check on the information aspects of corporate governance. In response to the accident:

ABC & Co. is required to **give an opinion on whether the financial statements give a true and fair view**, audit the validity of the expenses incurred, and assess the adequacy of provision and contingency made in response to the accident.

ABC & Co. need to **have an understanding of the internal controls on expenses incurred**, provision and contingency made in response to the accident, and should report any material weaknesses in internal control to the board and audit committee.

MC – Exam Questions Review



[Corporate Governance Practice] Jun 2012 – Case Answer 4c (Cont'd)

ABC & Co. should **communicate with the board or audit committee** about significant risks that require disclosure in the financial statements, any uncertainties about the going concern assumption, any disagreements they have with management about the financial statements, and so on.

ABC & Co. may be asked to **check whether Super Energy follows the provisions in the Corporate Governance Code** for the effectiveness of the system of internal control reviewed and reported on. This should cover all significant controls, including financial, operational and compliance controls and risk management systems.



Exam Questions Review

Dec 2011 – Case Qu 3

Corporate Governance Practice

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[Corporate Governance Practice] Dec 2011 – Case Qu 3 (Extracted)

Question

Dummy Real Estate Investment Trust (DREIT) is a mid-size real estate investment trust listed in Hong Kong. With a portfolio of 50 real estates comprising retail malls, commercial premises and car park facilities, DREIT was established by a trust deed (Trust Deed)

Since its listing on the Hong Kong Stock Exchange in December 2008, DREIT has been paying the Unitholders at about 90% of its net income and has demonstrated consistent growth in distribution per unit.

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[Corporate Governance Practice] Dec 2011 – Case Qu 3 (Extracted)

3) DREIT has established an audit committee to comply with the Listing Rules of the Hong Kong Stock Exchange.

Required:

- a) To what extent can the establishment of an effective audit committee improve DREIT's corporate governance in the context of external auditing, financial reporting and internal control? (8 marks)
- b) Describe some ways to gauge the effectiveness of DREIT's audit committee. (6 marks)

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[Corporate Governance Practice] Dec 2011 – Case Answer 3a

An effective audit committee can enhance the **effectiveness, accountability, transparency and objectivity** of the Manager's Board of Directors, and can also improve DREIT's corporate governance in the following ways:

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[Corporate Governance Practice] Dec 2011 – Case Answer 3a (Cont'd)

Financial reporting

- Improve the quality of financial reporting by reviewing the financial statements on behalf of DREIT's Board of Directors.
- Increase the involvement of the non-executive directors by assigning them to the audit committee to contribute independent viewpoints.
- Increase public confidence by raising the credibility and objectivity of DREIT's financial statements.

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[Corporate Governance Practice] Dec 2011 – Case Answer 3a (Cont'd)

External auditing

- Strengthen the position of DREIT's external auditor by providing an open channel of communication.
- Formulate a framework for DREIT's external auditor to maintain its independence when there are disputes with DREIT's management.

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[Corporate Governance Practice] Dec 2011 – Case Answer 3a (Cont'd)

Internal control

- **Strengthen the position of DREIT's internal auditor by separating it from executive management.**
- **Foster a culture of self-discipline, risk alertness and anti-fraud controls.**
- **Create a forum for DREIT's internal auditor in which they can raise issues of concern, and which they can use to get things done which might otherwise be difficult.**

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[Corporate Governance Practice] Dec 2011 – Case Answer 3b

The **effectiveness of DREIT's audit committee** may be gauged in the following ways:

The Manager's Board of Directors is equivalent to DREIT's governing body which should have a balanced composition of executives and non-executives (to maintain objectivity) drawing from a range of relevant expertise. As a subset of the Board, the audit committee should consist entirely of non-executive directors (at least 3) particularly in the fields of accounting and finance. Also, some directors should have no financial interest in DREIT in order to maintain their independence. **(1/3 of Board = INED)**

MC – Exam Questions Review



[Corporate Governance Practice] Dec 2011 – Case Answer 3b (Cont'd)

Adequate resources should be set aside for the audit committee, so that an adequate number of members with the right calibre are appointed for access to management, external auditors and internal auditors.

DREIT's audit committee with proper terms of reference derives its authority from DREIT's Board of Directors under the requirements of the Listing Rules. Without proper authority, an audit committee would not be able to exercise the appropriate influence.

MC – Exam Questions Review



[Corporate Governance Practice] Dec 2011 – Case Answer 3b (Cont'd)

DREIT's audit committee should be diligence which refers to the extent of willingness that DREIT's audit committee members work together to fulfill the requirements, including background study of agenda items, preparation of questions, checking progress, understanding problems and dealing with DREIT's management, internal auditors, external auditors and other stakeholders.



HKSA 320 (Clarified)

Audit materiality

MC – Audit materiality



Materiality should be calculated at the planning stages of all audit based on experience and judgment.

The consideration of materiality is divided into:

- Auditor has to satisfy both HKSAs.
 - **HKSA 320 (Clarified)** *Materiality in planning and performing an audit* – Materiality in planning and performing an audit of financial statements;
 - **HKSA 450 (Clarified)** *Evaluation of misstatements identified during the audit* – Materiality in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial statements.

Materiality in the context of an audit

The objective of the auditor is to **apply the perception of materiality in planning and performing the audit** and to evaluate the effect of identified and uncorrected misstatements on the financial statements. Auditor's determination of materiality is a matter of professional judgment.

MC – Audit materiality



Materiality in the context of financial reporting:

Financial reporting framework such as the HKFRS, discusses the concept of materiality in the context of the preparation and presentation of financial statements. The concept of materiality is discussed differently in different financial reporting frameworks. For example in HKAS 1 (Revised):

Materiality is an expression of the relative significance or importance of a particular matter in the context of financial statements as a whole.

Materiality assessment will help the auditors to decide:

- the **cut off point** on how much information should be obtained (**quantity**) and what **type** of information is relevant (nature)
- whether to **use sampling techniques**
- what **level of error** is likely to lead to a qualified audit opinion. It serves the objective of audit – ie express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

MC – Audit materiality



HKSA 320 (Clarified) requires an auditor to determine at least two types of materiality in planning an audit:

- **Materiality for the financial statements as a whole; and**
- **Performance materiality**

Auditors should consider **materiality and its relationship with audit risk** in conducting the audit

Auditors should plan and perform the audits so as to provide them with **sufficient (quantity) evidence** to give reasonable assurance that the financial statements are free from material misstatement and give a true and fair view.

Auditors should consider materiality when determining **the nature, extent and timeliness (NET) of audit procedures.**

MC – Audit materiality



Materiality in misstatements identified

Auditors should assess whether the **aggregate of uncorrected misstatements** that have been identified during the audit is material in all aspects when evaluating whether the financial statements have been prepared within an **applicable financial reporting framework**.

Materiality for the financial statements as a whole

HKSA 320 (Clarified) states that auditor, using professional judgment, shall determine materiality for **the financial statements as whole**, when establishing the overall audit strategy.

Materiality at the overall statement level may be different from the assertion level depending on the specific risks identified.

MC – Audit materiality



Performance materiality

Performance materiality means the amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of **uncorrected and undetected misstatements** exceeds materiality for the financial statements as a whole.

The auditor is required to determine performance materiality for purposes of:

- **Assessing** the risks of material misstatement; and
- Determining the **nature, timing and extent** of further audit procedures

Performance materiality is **set to reduce to an appropriately low level** the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeding materiality for the financial statements as a whole.



Exam Techniques for MC

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Common Techniques to pass MC



- A. Prepare your critical files**
- B. Only need 1 set of notes**
- C. Time yourself**
- D. Start practice writing**
- E. Don't just copy – use key words for application**
- F. Demonstrate logical thinking – sometimes no right or wrong**
- G. No need to highlight everything in the question booklet**
- H. Writing – legible to read**

MC Preparation with ETC



Knowledge Course: 10 Sessions

→ Boost your knowledge

Revision Course: 9 Sessions

→ Practice past papers and other ETC questions

Only got 2 months left – What shall you do?

- Do past papers with updated answers
- Practice writing out:
Progress test + Exam Pack (2 additional tests) + Final Mock
- Write as many questions out as possible
- Practice using your critical file
- Time yourself

Final Advice



The time to look-up the textbook is limited during an open-book exam

Students should:

- ✓ have a good understanding of the topics before going into the exam
- ✓ read the case and questions carefully
- ✓ answer what is being asked, not what they wanted to be asked
- ✓ identify the core issues of the question and allocate their time accordingly
- ✓ analyse the facts of the case and apply the tax rules or principles to arrive at the conclusion
- ✓ not copy large passages from the textbook
- ✓ use logical thinking to understand and respond to the questions

At **ETC**, it is our aim to encourage you. Thank you!



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