



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



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

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17 October 2013

QP Module C Seminar

Major or Difficult Syllabus



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Assessing Risks of Material Misstatements

Audit Risk Concept

The concept of audit risk is set out in HKSA 200 (Clarified) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the F/S are materially misstated. Audit risk is a function of detection risk and RoMM.

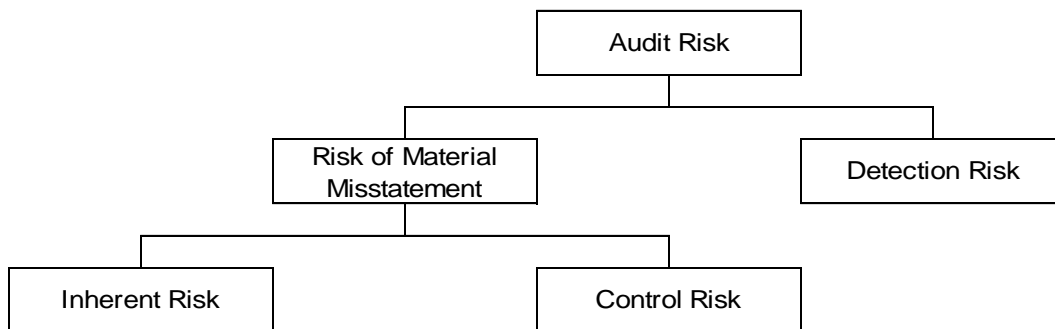
Detection Risk is the risk that the procedures performed by the auditor will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. However, detection risk can never be zero due to limitations of an audit.

RoMM is the risk that the F/S are materially misstated prior to audit. This consists of two components:



| Component of RoMM | Remark | |
|-------------------|--|--|
| Inherent risk | This refers to the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. | They are beyond the control of auditors. However, the auditors can address detection risk by designing audit procedures to <u>reduce RoMM to an acceptably low level</u> and thus minimise audit risk. |
| Control risk | <p>This refers to the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.</p> <p>Control risk can never be zero due to limitations of internal control.</p> | |

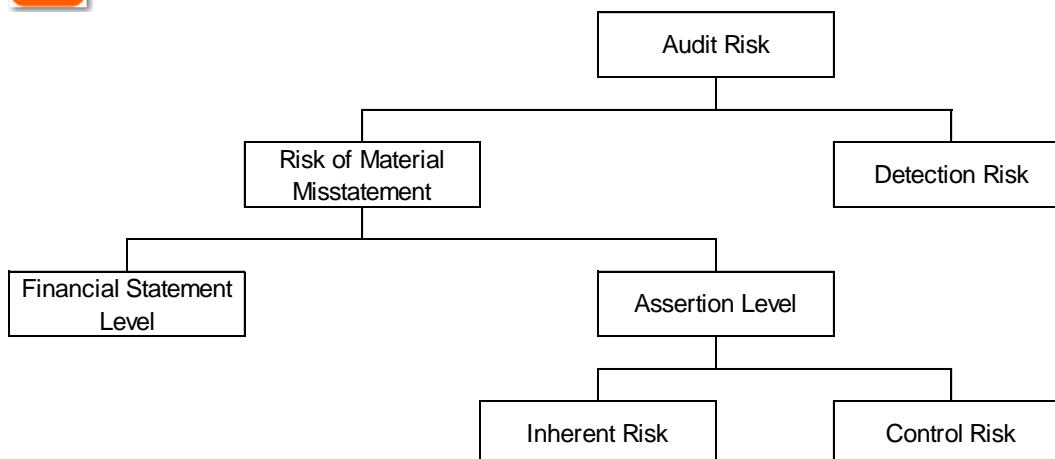
The relationship between the above components can be summarised in the below diagram:



HKSA 200 (Clarified) further states that the RoMM exists at two levels:

- **RoMM at the Financial Statement Level.** It refers to RoMM that relate pervasively to the F/S as a whole and potentially affect many assertions.
- **RoMM at the Assertion Level.** It refers to RoMM for specific classes of transactions, account balances and disclosures.

Thus, the above diagram can be further expanded as follows:



In a nutshell:

1. $Audit Risk = RoMM \times Detection Risk$
2. $Audit Risk = (Inherent Risk \times Control Risk) \times Detection Risk$
3. Inverse relationship between RoMM and Detection Risk: At a given level of audit risk, the greater the RoMM, the less the detection risk that can be accepted and thus the more persuasive audit evidence is required.

Assessing RoMM at the Assertion Level

We first look at the meaning of assertions.



Assertions for Balance Sheet:

| Assertion | Definition |
|--------------------------|--|
| Existence | Assets, liabilities and equity exist |
| Completeness | All assets, liabilities and equity that should have been recorded have been recorded |
| Rights and Obligations | The entity holds/controls the rights to assets. Liabilities are obligation of the entity |
| Valuation and Allocation | Assets, liabilities and equity are recorded at appropriate amounts |

Assertions for Income Statement:

| Assertion | Definition |
|----------------|--|
| Occurrence | Transactions and events recorded have occurred and pertain to the entity |
| Completeness | All transactions and events that should have been recorded have been recorded |
| Accuracy | Amounts and data relating to recorded transactions and events have been recorded appropriately |
| Cut-Off | Transactions and events recorded have been recorded in the correct accounting period |
| Classification | Transactions and events have been recorded in the proper F/S |

Assertions for Presentation and Disclosure:

| Assertion | Definition |
|---------------------------------------|--|
| Occurrence and rights and obligations | Disclosed events, transactions, and other matters have occurred and pertain to the entity. |
| Completeness | All disclosures that should have been included in the F/S have been included. |
| Classification and Understandability | Financial information is appropriately presented and described, and disclosures are clearly expressed. |
| Accuracy and Valuation | Financial and other information are disclosed fairly and at appropriate amounts. |

In assessing RoMM at the assertion level, generally the auditor may consider the following factors:



| Factors | Circumstances that may increase RoMM at Assertion Level |
|------------------------------|--|
| Nature of item | When the item is more susceptible to misappropriation or manipulations. |
| Degree of judgement involved | When the item is more susceptible to judgement (e.g. outcome of a court case). |
| Complexity | When the item is complex and may involve the use of expert (e.g. actuarial). |
| Non-routine or one-off | When the item is non-routine or one-off, the entity may be less experienced in dealing with this item. |
| Volume of transaction | When there is a high volume of transactions (especially near the year-end). |
| Previous misstatements | When the item has been misstated in prior years. |

Specific Accounting Standards and Audit Concerns

The following table summarises key accounting treatments of certain items under HKFRS and the corresponding key audit concerns:



| Items | | Key Accounting Treatments | Key Audit Concerns |
|-------------------------------|---------|---|---|
| Property, Plant and Equipment | HKAS 16 | <ul style="list-style-type: none"> • Measurement: Cost or Revaluation Model (surplus/deficit in reserve) • Capitalisation of cost directly attributable costs, including the estimated decommissioning costs if there is an obligation to incur the cost at the end of the life of the asset • Depreciation begins when it is in the location and condition necessary for it to be capable of operating in the manner intended by management • Disclose methods and significant assumptions used to estimate revaluated values, the effective date of the revaluation, and whether an independent valuer was used | <ul style="list-style-type: none"> • Ineligible costs may be capitalised • Revaluation may be subjective • Not depreciated when new asset begins to be in use • Useful life is unreasonable • Incorrect calculation of depreciation • If use revaluation model: may link to HKSA 540 (Clarified) and HKSA 620 (Clarified) |

| | | | |
|--|---------|---|---|
| Investment Property | HKAS 40 | <ul style="list-style-type: none"> Earns rental income and/or for capital appreciation Measurement: Fair Value or Cost Model | <ul style="list-style-type: none"> Fair value may be subjective Incorrect classification If use fair value model: may link to HKSA 540 (Clarified) and HKSA 620 (Clarified) |
| Impairment | HKAS 36 | <ul style="list-style-type: none"> Test impairment of cash-generating units: compare Carrying Amount with Recoverable Amount (higher of Value in Use and FV less Cost to Sell) <p>Impairment is required when there are indicators, or annually for:</p> <ul style="list-style-type: none"> Goodwill Intangible assets with indefinite life Intangible assets not yet available for use | <ul style="list-style-type: none"> Assets not impaired when indicators exist/annually Cash flow forecasts may be subjective and inaccurate Recoverable amount may be subjective |
| Provisions, Contingent Liabilities and Contingent Assets | HKAS 37 | <p>Provision: Recognise only if:</p> <ul style="list-style-type: none"> present obligation as a result of a past event; probable outflow of economic benefit; and measure reliably <p>Disclose Background and reconciliation</p> <p>Restructuring: constructive obligation if have detailed plan; raised valid expectation. E.g. implemented or announced</p> <p>Contingent Liability: Present obligation exists but outflow not probable or cannot be measure reliably</p> <p>Should not recognise but disclose:</p> <ul style="list-style-type: none"> description of the nature of the obligation expected timing of any outflows of economic benefits indication of the uncertainties about the amount or timing of those outflows <p>Contingent Asset: Possible asset from past events whose existence will be confirmed by uncertain future events</p> | <ul style="list-style-type: none"> May link to HKSA 501 (Clarified), HKSA 540 (Clarified) and HKSA 560 (Clarified) Present obligation not substantiated Measurement may be subjective Inadequate or incomplete disclosure |

| | | | |
|-----------------------|------------------------------------|---|---|
| | | <p>Should not recognise but disclose:</p> <ul style="list-style-type: none"> • Description of contingency • Estimate of financial effect | |
| Intangible Assets | HKAS 38 | <p>Overall criteria:</p> <ul style="list-style-type: none"> • Identifiable • Controlled by entity from past event • Probable future economic benefits <p>Separately Acquired & Acquire in Business Combination: Recognise if:</p> <ul style="list-style-type: none"> • Probable future economic benefits • Measure reliably <p>Measure at Cost/Revaluation less Amortisation less Impairment</p> <p>Internally Generated: Research must be expensed</p> <p>Development is recognised if:</p> <ul style="list-style-type: none"> • Technically feasible • Intend to complete • Commercially viable • Probable future economic benefits • Resources available to complete • Measure reliably <p>Measure at: Cost less Amortisation less Impairment</p> <p>If indefinite life: annual impairment</p> <p>No recognition of internally generated brand or goodwill</p> | <ul style="list-style-type: none"> • Recognition criteria not substantiate • Indefinite life or useful life not substantiate • Not reviewed for impairment |
| Financial Instruments | HKAS 32, HKAS 39, HKFRS 7, HKFRS 9 | <p>HKFRS 9 (will replace HKAS 39 in entirety): 4 Types:</p> <ul style="list-style-type: none"> • Financial assets at Amortised Cost • Financial assets at Fair Value • Financial liabilities at Amortised Cost • Financial liabilities at Fair Value through profit or loss | <ul style="list-style-type: none"> • May link to HKSA 540 • Fair value may be subjective • Incorrect calculation of amortised costs • Inadequate disclosure • Incorrect classification |

| | | | |
|-----------------------|-------------------|--|---|
| | | <p>HKAS 32:</p> <ul style="list-style-type: none"> Convertible debt instruments should be presented by two separate components Dividend to preference shareholders should be finance charge <p>HKFRS 7: Disclosure of financial instruments:</p> <ul style="list-style-type: none"> Concentration of risks Risk exposures Sensitivity analysis How the risks are managed and monitored | |
| Business Combinations | HKFRS 3 (Revised) | <p>In calculating goodwill:</p> <ul style="list-style-type: none"> Cost of investment should be recognised at fair value Directly attributable costs should be included in cost of investment. Value of identifiable assets (assets acquired and liabilities assumed) at acquisition-date fair values (i.e. purchase price allocation). Contingent liabilities (to the extent present obligation exists and fair value can be measured reliably) should be included. | <ul style="list-style-type: none"> May link to HKSA 600 (Clarified) and HKSA 540 (Clarified) Valuation of identifiable assets and liabilities Completeness of contingent liability |

Responding to Risks of Material Misstatements

Responses to RoMM at the Assertion Level

The auditor shall design and perform further audit procedures whose **n**ature, **t**iming and **e**xtent (“NET”) are based on and are responsive to the assessed risks of material misstatement at the assertion level.



| | |
|--------|---|
| Nature | It refers to the audit approach and what type of audit testings would be performed. |
| Timing | <p>It refers to whether to perform audit procedures at interim stage or at period end.</p> <p>Typically, if the RoMM is higher, audit procedures should be performed nearer or at period end or at unpredictable times.</p> |
| Extent | <p>It refers to the quantity of audit evidence. Typically, the higher the RoMM the greater extent is required.</p> <p>One way to increase extent is by increasing sample size.</p> |

Nature - Audit Approach

There can be 2 audit approaches:

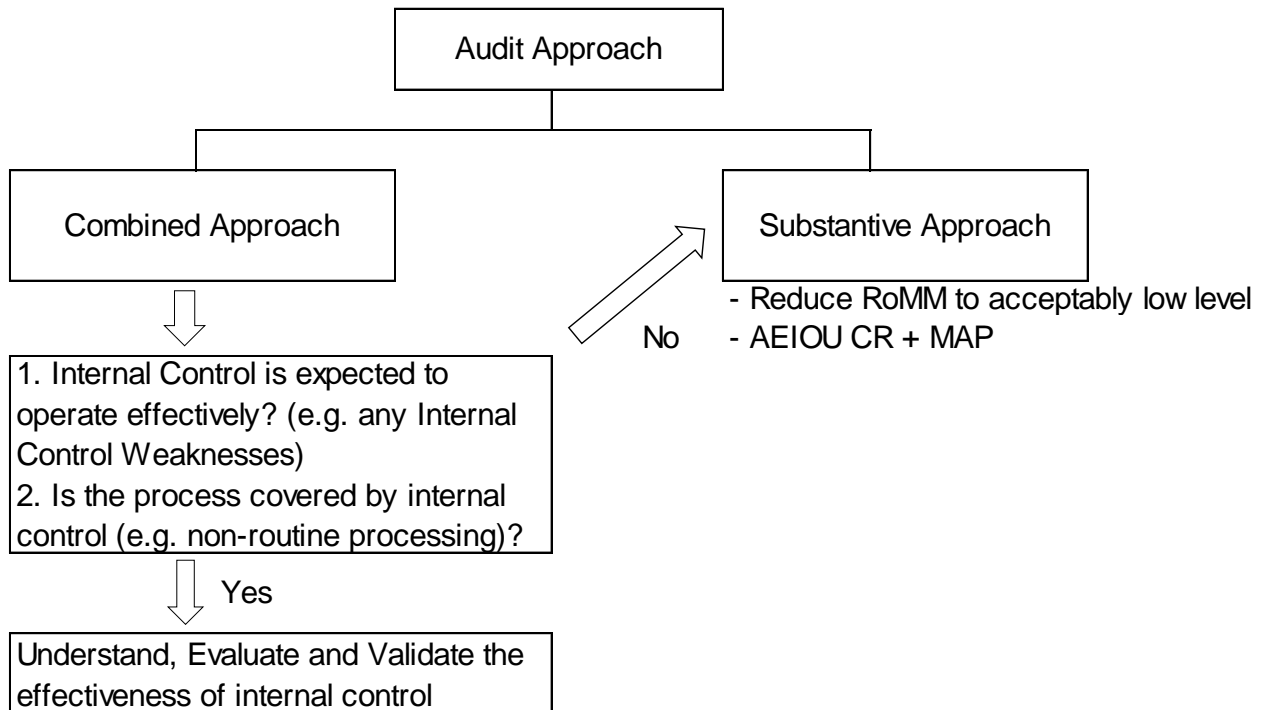


| Approach | Remark |
|----------------------|--|
| Substantive Approach | Only substantive procedures would be performed. Nevertheless, the auditor may perform one or in combination of test of details and substantive analytical procedures. |
| Combined Approach | Perform both tests of controls and substantive procedures. |

In essence, the key determination factor is: are we going to perform tests of controls? The determination of audit approach can be illustrated by the following flowchart:



Determine Audit Approach



Nature - Types of Audit Testings

Before going further, we first look at how auditors can obtain audit evidence (mnemonic “AEIOU CR”):



| Techniques | Remarks |
|--|---|
| <u>A</u> lytical Procedures | <ul style="list-style-type: none"> Cannot address existence and occurrence Useful for valuation and allocation, accuracy and completeness |
| <u>E</u> nquiry | <ul style="list-style-type: none"> Useful for most assertions |
| <u>I</u> nspection | <ul style="list-style-type: none"> Useful for most assertions |
| <u>O</u> bservation | <ul style="list-style-type: none"> Useful for physical assets |
| Recalc <u>U</u> lation and reperformance | <ul style="list-style-type: none"> Useful for valuation and allocation and accuracy |
| <u>C</u> onfirmation | <ul style="list-style-type: none"> Useful for most assertions (except for valuation and allocation of accounts receivables) |
| <u>R</u> econciliation | <ul style="list-style-type: none"> Cannot address existence and occurrence Useful for valuation & allocation, accuracy and completeness |

Designing Specific Audit Procedures

It is virtually not possible to list out all audit procedures to address each item by assertions. In fact, the audit procedures to address the same assertion of the same item would vary according to the specific circumstances. Nevertheless, the below “MAP” approach would prove to be useful which makes use of “AEIOU CR” model.

| | |
|--------|--|
| Step 1 | Identify the item/transaction to test |
| Step 2 | Identify the assertions to be addressed |
| Step 3 | Think about the accounting documents connected with the item/transaction |
| Step 4 | Adopt “MAP” approach |



| Approach | Sample Substantive Procedures |
|--|---|
| Test what <u>M</u> anagement has done (E, U) | <ul style="list-style-type: none"> ▪ Enquire into/Discuss with management regarding [ascertain the assertions] ▪ Assess experience and competence of staff performing the [management's actions] ▪ Examine compliance of accounting policies with HKFRS ▪ Reperform/recalculate management's calculation |
| <u>A</u> uditor designed procedures (A, I, O, C, R) | <p>Basic procedures:</p> <ul style="list-style-type: none"> ▪ Obtain reconciliations/breakdowns showing [.....] ▪ Agree opening balance to prior year's audited F/S ▪ Agree closing balance to F/S ▪ Check mathematical accuracy of the [accounting record] <p>Main procedures:</p> <ul style="list-style-type: none"> ▪ Vouch [supporting documents] for breakdown/movement items ▪ Vouch or Physically Observe from list to floor ▪ Vouch or Physically Observe from floor to list ▪ Send confirmations to [...] confirming [...] ▪ Test reconciling items by vouching [.....] and obtain explanations.... ▪ Review minutes and correspondence for.... ▪ Review agreements for..... ▪ Analytical Procedures (Compare A to B...) ▪ Search for unrecorded liabilities <p>Procedures involving Accounting Estimates or Fair Value:</p> <ul style="list-style-type: none"> ▪ Assess reasonableness of models and assumptions used by management ▪ Develop an independence estimates and compare with management's calculations (may also use Expert) ▪ Review subsequent events to assess reasonableness ▪ Obtain LoR to confirm [state specific matters] |
| <u>P</u> ost balance sheet indication | <ul style="list-style-type: none"> ▪ Check for any subsequent settlements |

Practice Question – Assessing and Responding to RoMM
(Adopted from HKICPA Module C June 2012)

CASE

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.

Super Energy’s headquarters are in Hong Kong. It is vertically integrated from exploration and production, refining, distribution and marketing to petrol station retailing. Its largest oil production plant is in America.

Super Energy’s track record of corporate social responsibility has been mixed. The company has been involved in a number of major environmental and safety incidents and received criticism for its political influence. However, it is also the first major oil company to publicly acknowledge the need to take steps against climate change and take actions to reduce emissions. Super Energy currently invests over HK\$10 billion per year in the development of renewable energy sources and environmental protection.

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.

The company has committed to take responsibility for the clean-up and compensate victims of the accident. As of 31 December 2011, the company reported that they have spent HK\$20 billion on the response activities.

ABC & Co. is the auditor of Super Energy. ABC & Co. and Super Energy’s board of directors meet with the Audit Committee quarterly. ABC & Co. also holds regular meetings with the Internal Audit and reviews the Internal Audit investigation reports.

There were two Internal Audit investigation reports issued in December 2011 which caused particular concern to ABC & Co. In these reports by the Internal Audit, they found a significant access control deficiency over the Flex Accounts which are the general ledger used by Super Energy worldwide, and some exploration and production facilities were potentially overstated due to certain significant controls over fixed asset registration and valuation were not properly exercised by the operation team.

Here is an extract of the financial data of Super Energy:

| | Year ended 31 December 2011 (Unaudited) HK\$ billion | Year ended 31 December 2010 (Audited) HK\$ billion |
|--------------------------|---|---|
| Revenue | 250 | 220 |
| Profit / loss before tax | (50) | 30 |
| Total assets | 3,790 | 3,856 |
| Total liabilities | 2,823 | 2,998 |

Question 1 (18 marks – approximately 32 minutes)

- (a) Assuming you are ABC & Co., after reading the Internal Audit report about the potential overstatement of certain exploration and production facilities, evaluate and explain the financial statement assertions that concern you most relating to fixed assets.
(3 marks)
- (b) In response to your risk assessment explained in Question 1(a), what audit procedures would you consider in addressing the risk of material misstatements you identified?
(15 marks)

Question 2 (13 marks – approximately 23 minutes)

- (a) Assuming you are ABC & Co., in response to the accident in the Gulf of Sankala, identify three risks of material misstatements of Super Energy's financial statement as at 31 December 2011.
(3 marks)
- (b) In response to the risk of material misstatements identified in Question 2(a), suggest and discuss the audit procedures that you would perform in order to address the assessed risk of material misstatements.
(10 marks)

Answer – Assessing and Responding to RoMM**Answer 1(a)**

Existence and completeness due to certain significant controls over fixed asset registration were not properly implemented by the operation team;

Valuations due to certain significant control over fixed asset valuation were not properly implemented by the operation team.

Answer 1(b)

In response to the assessed risks of the fixed assets described in 1(a), ABC & Co. should consider whether the audit procedures are affected in terms of scope (e.g. additional procedures required) and extent (e.g. more sample sizes) in response to the risk identified.

Some audit procedures are suggested below:

Existence & Completeness

- Understand the scope of the Internal Audit investigation report, e.g. location, business processes and controls.
- Understand from the Internal Audit and management the root cause of the control deficiencies identified and reassess the risk of material misstatement to fixed assets.
- Confirm that Super Energy physically inspects all items in the fixed asset register at year end.
- Inspect high value items from the fixed asset register at year end. Confirm the items inspected exist and are in good condition and have correct serial numbers.
- Confirm that Super Energy reconciles opening and closing assets by serial numbers as well as amounts.
- Obtain the fixed asset register with gross book value, accumulated depreciation and net book value, and reconcile with the opening position.
- Compare the fixed asset balance in the general ledger with the fixed assets register and obtain explanations for any differences.
- For a sample of fixed assets which physically exist, confirm that they are recorded in the fixed asset register.

Valuation

- Understand the scope of the Internal Audit investigation report, e.g. location of the exploration and production facilities that may have been potentially overstated or understated.
- Understand from Internal Audit and management the root cause of the control deficiencies identified and reassess the risk of material misstatement to fixed assets.
- Verify the valuation of the exploration and production facilities in the valuation report.
- Consider the source of valuation and review the valuation report, e.g. experience of valuer, scope of work, methods and assumptions used, and valuation bases are in line with accounting standards.

Answer 2(a)

In response to the accident, assessing the risk of material misstatements relating to Super Energy's financial statements as a whole, ABC & Co. should consider the following:

- The occurrence and completeness of the expenses incurred and paid relating to the accident.
- The adequacy of the provision for claim and litigation provided against the parties affected by the accident.
- The adequacy of the disclosure made in the financial statements in response to the accident e.g. provision and contingency made.
- The potential asset impairment loss after the accident.

Answer 2(b)

ABC & Co. should consider the below audit procedures.

In response to the risk of material misstatement relating to the expenses incurred and paid:

- Understand and evaluate the controls in place for initiating and recording the expenses incurred and paid.
- Identify and validate the key controls relating to the expenses incurred and paid.
- Review the voucher register and expense ledger for large or unusual items.
- Check expenses recorded in the expense ledger or cash to supporting documents such as approved requisition forms to ensure the expenses are valid and are recorded in the correct expenses ledger.
- Test the arithmetical accuracy (i.e. by recalculating the amounts) on suppliers' invoices, voucher register and expense ledger.
- Perform procedures to search for unrecorded liabilities.

In response to the risk of material misstatement relating to the provision for claim and litigation:

- Make appropriate inquiries of management and others within Super Energy including in-house legal counsel.
- Review minutes of meetings of those charged with governance and correspondence with the entity's lawyers.
- Examine legal expenses accounts.
- Meet with Super Energy's external lawyers to seek their advice and request an opinion letter if necessary.
- Request management, or those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements.
- Obtain details of all provisions for claim and litigation which have been included in the financial statements.
- Obtain a detailed analysis of all provisions for claim and litigation showing opening balances, movements and closing balances.
- Determine for each material provisions for claim and litigation whether Super Energy has a present obligation as a result of past events by reviewing the correspondence relating to the item and holding discussions with management.
- Compare the amount provided with the post year end payments and with any amount paid in the past for similar items.

In response to the adequacy of the disclosure made in the financial statement:

- Consider the adequacy of disclosure of provision for claim and litigation and contingent liabilities in the financial statements in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

In response to the potential asset impairment loss:

- Discuss with management the estimate of asset loss in the accident and understand their basis of the assessment.
- Verify the valuation of the asset in the valuation report.

Quality Control

References:

1. HKSQC 1 (Clarified) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*
2. HKSA 220 (Clarified) *Quality Control for an Audit of Financial Statements*

Like any business, it is important to have quality control in place so that the products are of an acceptable quality. In the context of an audit, the 'product' is the auditor's report which is to provide assurance to the shareholders about the truth and fairness of the F/S. Anything less than a high quality product of an audit would jeopardise the creditability of the auditor's report. Arguably, poor quality control would damage the general public's confidence on the auditing profession.

HKSQC 1 (Clarified) addresses quality control at the firm level, whereas HKSA 220 (Clarified) addresses quality control at the engagement partner level.

The objectives of HKSQC 1 (Clarified) and HKSA 220 (Clarified) are to establish system of quality control to provide reasonable assurance that:

- professional standards and regulatory and legal requirements are complied with
- reports issued are appropriate in the circumstances

The key requirements of HKSQC 1 (Clarified) and HKSA 220 (Clarified) are set out in the below table.



| Areas | HKSQC 1 (Clarified) - FIRM | HKSA 220 (Clarified) - INDIVIDUAL ENGAGEMENT PARTNER |
|---|--|---|
| Leadership Responsibilities for Quality | The leadership of the firm should have the following attributes: <ul style="list-style-type: none"> ▪ sufficient and appropriate experience ▪ ability to carry out the leadership roles ▪ necessary authority to carry leadership roles | The engagement partner should: <ul style="list-style-type: none"> ▪ take responsibility for the overall quality of each audit engagement ▪ emphasize importance of audit quality |
| Compliance with Ethical Requirements including Independence | The firm should: <ul style="list-style-type: none"> ▪ communicate its independence requirements to its staff ▪ identify and address threats to independence ▪ establish channel to communicate any breaches of ethical requirements ▪ obtain written confirmation of compliance with independence policies and procedures from all staff at least annually | The engagement partner should: <ul style="list-style-type: none"> ▪ remain alert for evidence of non-compliance with ethical requirements ▪ conclude on independence compliance ▪ eliminate threats by putting safeguards in place ▪ address any breaches |

| | | |
|----------------------------|---|---|
| Acceptance and Continuance | <ul style="list-style-type: none"> • Establish policies and procedures for the acceptance and continuance of client relationships and specific engagements • Assess whether it is competent to perform the engagement and has the capabilities, including time and resources • Assess whether it can comply with relevant ethical requirements • Consider the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity • Document how issues (if any) are resolved | The engagement partner should: <ul style="list-style-type: none"> • ensure that appropriate procedures regarding acceptance and continuance have been followed • determine that conclusions reached are appropriate If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier: <ul style="list-style-type: none"> • communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action |
| Human Resources | The firm should: <ul style="list-style-type: none"> ▪ establish policies to ensure the firm has sufficient personnel with competence, capabilities and commitment to ethical principles ▪ assign an engagement partner to each engagement and communicate the identity and role of the engagement partner to client management and TCWG ▪ ensure engagement teams assigned have sufficient competence, capabilities and time | The engagement partner should: <ul style="list-style-type: none"> ▪ ensure the team has sufficient personnel with competence, capabilities and commitment to ethical principles ▪ ensure team members assigned have sufficient competence, capabilities and time |
| Engagement Performance | <p>Consultation:</p> <ul style="list-style-type: none"> ▪ Consultation should be conducted on difficult or contentious matters ▪ Sufficient resources should be made available for consultation ▪ Matters consulted should be documented. ▪ Conclusion from consultations should be implemented | <p>Direction:</p> The engagement partner should inform team members about: <ul style="list-style-type: none"> ▪ their responsibilities to plan and perform with professional skepticism ▪ objectives of work performed ▪ nature of client's business ▪ risk-related issues ▪ audit approach |

| | | |
|------------|---|---|
| | <p>Quality Control Review: It should include:</p> <ul style="list-style-type: none"> ▪ objective evaluation of significant judgements made by the engagement team ▪ review of F/S ▪ evaluate conclusions reached is appropriate to proposed reports <p>Auditor's report should not be issued until the completion of the engagement quality control review.</p> | <p>Review: The engagement partner should ensure:</p> <ul style="list-style-type: none"> ▪ work performed complies with professional standards and regulatory requirements ▪ significant matters have been raised ▪ the need to revise nature, timing and extent of audit procedures are considered ▪ work performed supports the conclusions and documented ▪ audit evidence obtained is sufficient and appropriate <p>Consultation: The engagement partner should:</p> <ul style="list-style-type: none"> ▪ ensure the engagement team has undertaken appropriate consultation on any significant or contentious matters ▪ involve in the consultation ▪ ensure the conclusions reached are implemented <p>Quality Control Review: The engagement partner should:</p> <ul style="list-style-type: none"> ▪ Ensure quality control reviewer is appointed ▪ Discuss significant matters with quality control reviewer <p>Auditor's report should not be issued until the completion of the engagement quality control review.</p> |
| Monitoring | <p>The firm should:</p> <ul style="list-style-type: none"> ▪ ensure system of quality control is relevant, adequate and effective ▪ evaluate the effect of deficiencies | <p>The engagement partner should consider:</p> <ul style="list-style-type: none"> ▪ whether deficiencies may affect the engagement ▪ whether the measures taken by the firm are sufficient in the context of that engagement |

Related Parties

Introduction

Related party relationships are a normal feature of commerce and business. However, a related party relationship could have an effect on the profit or loss and financial position of an entity because:

- Related parties may enter into transactions that unrelated parties would not;
- Transactions between related parties may not be made at the same amounts as between unrelated parties.

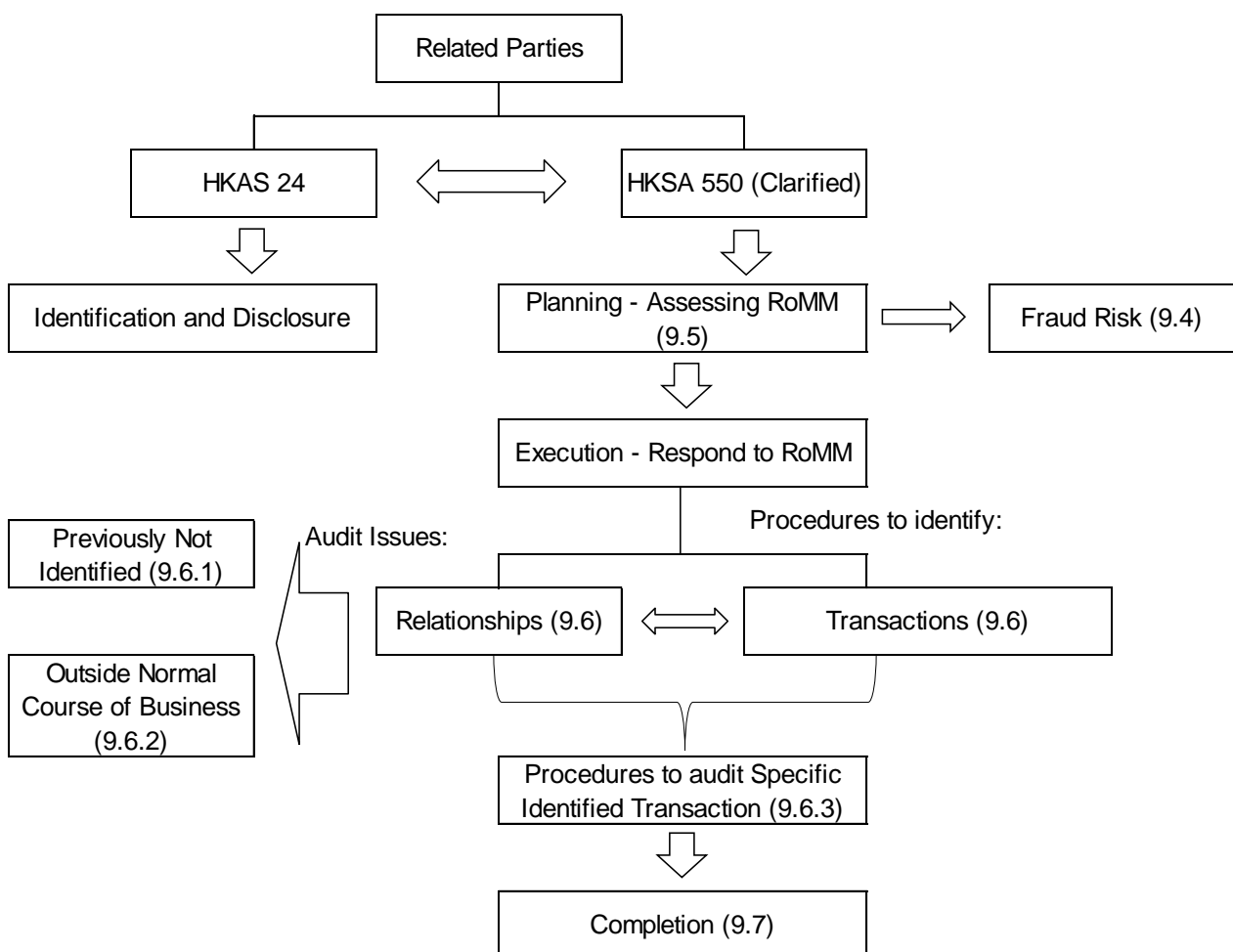
Therefore, knowledge of an entity’s transactions, outstanding balances and relationships with related parties may affect assessments of its operations by F/S users. As such, there is an accounting standard HKAS 24 (Revised) *Related Party Disclosures* that requires that related party relationships and transactions should be identified and disclosed.

Reference: HKSA 550 (Clarified) *Related Parties*

The overall mindmap for HKSA 550 (Clarified) is as follows:



Mindmap - HKSA 550 (Clarified)



9.1 Definition of Related Parties

The definition of related parties (“RP”) under HKSA 550 (Clarified) follows the definition in HKAS 24 (Revised) which is set out below:



- (a) A person or a close member of that person’s family is related to a reporting entity if that person:
- (i) has control or joint control over the reporting entity;
 - (ii) has significant influence over the reporting entity; or
 - (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
- (b) An entity is related to a reporting entity if any of the following conditions applies:
- (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
 - (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
 - (iii) Both entities are joint ventures of the same third party.
 - (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
 - (v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
 - (vi) The entity is controlled or jointly controlled by a person identified in (a).
 - (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

In other cases where the applicable financial reporting framework establishes minimal or no RP requirements, HKSA 550 (Clarified) states the following definition:

- (a) A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
- (b) Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
- (c) Another entity that is under common control with the reporting entity through having:
 - i. Common controlling ownership;
 - ii. Owners who are close family members; or
 - iii. Common key management.

Essentially, there is no significant difference in definition between HKAS and HKSA.

9.2 Audit Concerns for Related Parties

Typically, the presence of RP transactions would pose a higher RoMM because it is often difficult to identify RP due to:

- RP transactions may not be self-evident to the auditors.
- RP transactions may not be conducted under normal market terms and conditions (arm’s length). In some cases, some RP transactions may be conducted without any monetary charges.
-

- Management may take active steps to conceal the identities, relationships and transactions with certain RP.
- RP may operate through an extensive and complex range of relationships and organisational structures.
- Information systems of the entity may be ineffective at identifying or summarising transactions and outstanding balances between the entity and its RP.

Therefore, given the potential for undisclosed related party relationships and transactions, it is important that we as auditors plan and perform the audit with professional skepticism.

9.3 Responsibilities and Objectives of auditor in respect of Related Parties

The objectives of the auditor are:

- (a) obtain an understanding of related party relationships and transactions sufficient to be able:
 - to recognise fraud risk factors, if any, arising from RP relationships and transactions that are relevant to the identification and assessment of RoMM due to fraud
 - to conclude, based on the audit evidence obtained, whether the F/S, insofar as they are affected by those relationships and transactions, achieve fair presentation
- (b) obtain sufficient appropriate audit evidence about whether RP relationships and transactions have been appropriately identified, accounted for and disclosed in the F/S in accordance with HKAS 24 (Revised)

HKAS 24 (Revised) requires identification and disclosure of RP relationships, transactions or balances. In order to ensure the F/S complies with HKAS 24 (Revised), the auditor is responsible perform audit procedures to identify, assess and respond to the RoMM arising from the entity's failure to appropriately account for or disclose RP relationships, transactions or balances.

9.4 Related Parties and Fraud

Due to the nature of RP, fraud may be more easily committed through RP. Having significant RP may increase fraud risks.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. The risk of management override of controls is higher if management has relationships that involve control or significant influence with parties with which the entity does business because these relationships may present management with greater incentives and opportunities to perpetrate fraud.

For example, management's financial interests in certain RP may provide incentives for management to override controls by:

- directing the entity, against its interests, to conclude transactions for the benefit of these parties, or
- colluding with such parties or controlling their actions.

Examples of possible fraud include:

- creating fictitious terms of transactions with RP designed to misrepresent the business rationale of these transactions
- fraudulently organising the transfer of assets from or to management or others at amounts significantly above or below market value
- engaging in complex transactions with RP, such as special-purpose entities, that are structured to misrepresent the financial position or financial performance of the entity.

9.5 Planning – Understanding and Risk Assessment

The following table sets out the key requirements:

| Requirements | Remarks |
|--|---|
| Obtain an understanding of RP relationships and transactions | <p>Procedures include:</p> <ul style="list-style-type: none"> • Discuss among the engagement team • Inquire of management regarding: <ol style="list-style-type: none"> 1. The identity of the entity's RP, including changes from the prior period; 2. The nature of the relationships between the entity and these RP; 3. Whether the entity entered into any transactions with these RP during the period and, if so, the type and purpose of the transactions. • Inquire of management and others within the entity to obtain understanding of the internal controls (see Note 1 below) relating to: <ol style="list-style-type: none"> 1. Identify, account for, and disclose RP relationships and transactions in accordance with HKAS 24 (Revised); 2. Authorise and approve significant transactions and arrangements with related parties; 3. Authorise and approve significant transactions and arrangements outside the normal course of business. <p>(N.B. "Others within the entity" are those considered likely to have knowledge of entity's RP and relevant controls but are not part of management, such as internal auditors, those charged with governance, legal counsel)</p> |
| Identify and Assess RoMM associated with RP Relationships and Transactions | <p>For identified and assessed RoMM, the auditor shall determine whether any of those risks are significant risks.</p> <p>In particular, significant related party transactions outside the entity's normal course of business should be treated as giving rise to significant risks.</p> |
| Maintain Alertness for RP Information when reviewing records or documents | <p>When inspecting records or documents, the auditor shall remain alert for arrangements or other information that may indicate the existence of RP relationships or transactions that management has not previously identified or disclosed to the auditor.</p> |

Note 1: Controls over RP relationships and transactions may be deficient or non-existent for a number of reasons, such as:

- The low importance attached by management to identifying and disclosing RP relationships and transactions
- The lack of appropriate oversight by TCWG

- An intentional disregard for such controls because RP disclosures may reveal information that management considers sensitive (e.g. the existence of transactions involving family members of management)
- An insufficient understanding by management of the RP requirements of HKAS 24 (Revised)

9.6 Execution – Responding to RoMM associated with Related Parties Relationships and Transactions

The first step is to perform audit procedures to identify RP relationships and transactions:



| Identification of: | Procedures |
|--------------------|---|
| Relationships | <p>Review information provided by management of identification of all known RP.</p> <p>Obtain group chart and assess against relationships that fall within the definition of RP</p> <p>Perform audit procedures regarding the completeness of such information provided by management, including:</p> <ul style="list-style-type: none"> • review prior year working papers (N/A if first audit) • review management procedures for identification of RP • inquire to directors and officers within the entity such as names of close family members, controlling or significant interest in other entities • review shareholder records • review minutes of meetings of shareholders and directors • review income tax returns and other information supplied to regulatory authorities such as annual return <p>Ensure the RP relationship are required to be disclosed in accordance with HKAS 24 (Revised)</p> |
| Transactions | <p>Obtain confirmation of directors' remuneration (N.B. director's emolument is a required disclosure under Hong Kong Companies Ordinance)</p> <p>Review prior year working papers</p> <p>Review minutes of meetings of shareholders and directors</p> <p>Consider the adequacy of control activities over the authorisation and recording of RP transactions</p> <p>Confirm the terms and amount of the transaction with RP</p> <p>Inspect information in possession of the RP (e.g. contracts)</p> <p>Stay alert for transactions which appear unusual and may indicate existence of previously unidentified RP</p> <p>Obtain written representation from the management concerning the completeness of RP information and adequacy of disclosure in the F/S</p> |

Throughout the course of the audit, there could be two audit issues related to RP which include:

- there are RP relationships or transactions that are not previously identified
- there are RP transactions that are outside normal course of business

9.6.1 Related Parties Relationships or Transactions that are Previously Not Identified

When auditors identified RP relationships or transactions that are previously not identified, it may pose higher RoMM.

Examples of arrangements that may indicate the existence of RP 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

In such case, the auditor shall:

- promptly communicate the relevant information to the other members of the engagement team
- request management to identify all transactions with the newly identified RP for the auditor's further evaluation;
- inquire as to why the entity's controls over RP relationships and transactions failed to enable the identification or disclosure of the RP relationships or transactions
- perform appropriate substantive audit procedures relating to such newly identified RP or significant RP transactions
- reconsider the risk that other RP or significant RP transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary
- if the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

9.6.2 Related Parties Transactions that are Outside the Normal Course of Business

Unless restricted by relevant laws and regulations, there is nothing wrong with the entity entering into transactions that are outside the normal course of business. Having said, it is important that such transactions are authorised and approved by appropriate level of management.

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
- transactions with circular arrangements (e.g. sales with a commitment to repurchase)
- transactions under contracts whose terms are changed before expiry

In such case, the auditor shall:

- inspect the underlying contracts or agreements and evaluate whether:
 - ✓ the business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets
 - ✓ the terms of the transactions are consistent with management's explanations
 - ✓ the transactions have been appropriately accounted for and disclosed in accordance with HKAS 24 (Revised)
- obtain audit evidence that the transactions have been appropriately authorised and approved

If the business rationale from the RP's perspective that appears inconsistent with the nature of its business may represent a fraud risk factor.

9.6.3 Specific Audit Procedures on Identified Related Party Transactions

In exam, you may be asked for specific audit procedures on identified RP transactions, where you should make use of the AEIOU CR approach.

Whilst the procedures depend on the transactions set out in the questions, the below table sets out the approach how to tailor your audit procedures:



| Focus | Sample Procedures |
|--|---|
| Existence and Occurrence | <p>Inspect the underlying documents (e.g. invoices, agreements)</p> <p>Send confirmations to counterparty to confirm the transactions and any outstanding balances</p> <p>Read the F/S, if available, of the identified RP for evidence of the transactions in the RP's accounting records</p> |
| Terms (whether they are in arm's length) | <p>Inspect the underlying documents (e.g. invoices, agreements) and review the relevant terms</p> <p>Send confirmations to counterparty to confirm the the purposes, specific terms or amounts of the transactions</p> <p>Compare the relevant terms to those of an identical or similar transaction with one or more unrelated parties</p> <p>Engage an external expert to determine a market value and to confirm market terms and conditions for the transaction</p> |
| Completeness of RP transactions with the identified RP | <p>Send confirmations to counterparty to confirm the transactions and any outstanding balances</p> <p>Obtain written representation from the management that all transactions with the identified RP has been disclosed in the F/S</p> |
| Disclosure of the identified RP transactions | <p>Review the disclosure note in the F/S</p> <p>Agree the disclosure note to the details of the identified RP transactions</p> |

9.7 Completion - Evaluation of the Accounting for and Disclosure of Identified Related Party Relationships and Transactions

In forming an opinion on the F/S, the auditor shall:

- evaluate whether the identified RP relationships and transactions have been appropriately accounted for and disclosed in accordance with HKAS 24 (Revised)
- Evaluate whether the effects of the RP relationships and transactions prevent the F/S from achieving fair presentation or cause the F/S to be misleading
- obtain written representations from management relating to the completeness of identification and disclosure of RP relationships and transactions
- communicate with TCWG significant matters arising during the audit in connection with the entity's RP

Practice Question – Related Party Transaction**Question – Related Party Transaction**

You are the audit manager at Leung & Leung, responsible for the audit of ABC limited.

You are currently reviewing the audit file completed by your audit senior in relation to accounts receivable, amounting to HK\$300,000. You noted that the audit senior have requested and obtained a management representation stating the following:

1. that the amount is owed to ABC from XYZ (which is not audited by Leung & Leung),
2. that XYZ is controlled by the chief executive Mr. Tong; and
3. that the balance is likely to be received six months after ABC's year end.

Because the accounts receivable balance is immaterial to the ABC, the working papers noted that no further work was considered necessary. No disclosure has been made in the financial statements regarding the balance.

Required:

Comment on the matters you should consider and recommend further audit procedures that should be carried out.

(10 marks)

Answer – Related Party Transaction

Audit consideration

Despite the accounts receivables is immaterial in monetary terms. However, the details of the transaction could make it material by nature.

XYZ is controlled by Mr. Tong, who is a key management personnel of ABC. It appears that Mr. Tong is in a position of control/significant influence over the two companies, and thus the two companies are considered to be related in accordance with HKAS 24 (Revised) *Related Party Disclosures*.

Also, there is currently a non-compliance with HKAS 24 as no disclosure has been made in the notes to the financial statements.

According to HKSA 550 (Clarified) *Related Parties*, Leung & Leung should perform audit procedures to obtain sufficient appropriate audit evidence about whether the relationship between ABC and XYZ and their transactions have been appropriately identified, accounted for and disclosed in accordance with HKAS 24.

Valuation of accounts receivable

A receivable should only be recognised if it will give rise to future economic benefit, i.e. a future cash inflow. It appears that the receivable is long outstanding – if the amount is unlikely to be recovered then it should be written off as a bad debt and the associated expense recognised.

Although a representation has been received indicating that the amount will be paid to ABC, Leung & Leung should assess whether this constitutes sufficient and appropriate audit evidence, in the lights of whether other audit evidence (e.g. circulating debt's confirmation) is reasonably be expected to exist.

In the case of ABC and XYZ should perform further audit procedures as follows:

Leung & Leung should perform further audit procedures as follows:

- 1) Request additional written representation from Mr. Tong detailing:
 - the exact nature of his control over XYZ, i.e. if he is a shareholder then state his percentage shareholding, if he is a member of senior management then state his exact position within XYZ
 - an explanation as to why in his opinion the balance is recoverable
 - a specific date by which the amount should be expected to be repaid
 - a confirmation that there are no further balances outstanding from XYZ, or any further transactions between XYZ and ABC

- 2) Review the terms of any written confirmation of the amount, such as a signed agreement or invoice, checking whether any interest is due to ABC. The terms should be reviewed for details of any security offered, and the nature of the consideration to be provided in settlement.
- 3) From discussion with Mr. Tong, obtain an understanding of the business purpose of the transaction whether this balance arises from transaction that is outside normal course of business of ABC.
- 4) Review the board minutes for evidence of any discussion of the transaction and the recoverability of the balance outstanding.
- 5) Obtain the most recent audited financial statements of XYZ and:
 - ascertain whether Mr. Tong is disclosed as a related party,
 - review the disclosure notes to find any disclosure of the transaction, where it should be described as a related party liability
 - perform a liquidity analysis to establish whether the outstanding amount can be repaid from liquid assets.