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

MEMBERS' HANDBOOK

Update No. 203

(Issued 29 June 2017)

VOLUME III

Document Reference and Title	*Instructions*	*Explanations*
Contents of Volume III	Discard the existing pages i - v and replace with the revised pages i - v.	Revised contents page
HONG KONG STANDARDS ON AUDITING		
HKSA 200 (Clarified), *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*	Discard HKSA 200 (Clarified) revised in February 2015.	Note 1
HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*	Discard HKSA 200 revised in January 2016 and replace with the attached HKSA 200.	Note 2
HKSA 210 (Clarified), *Agreeing the Terms of Audit Engagements*	Discard HKSA 210 (Clarified) revised in June 2014.	Note 1
HKSA 210, *Agreeing the Terms of Audit Engagements*	Discard HKSA 210 revised in August 2016 and replace with the attached HKSA 210.	Note 2
HKSA 220 (Clarified), *Quality Control for an Audit of Financial Statements*	Discard HKSA 220 (Clarified) revised in February 2015.	Note 1
HKSA 220, *Quality Control for an Audit of Financial Statements*	Discard HKSA 220 revised in August 2015 and replace with the attached HKSA 220.	Note 2

HKSA 230 (Clarified), *Audit Documentation*	Discard HKSA 230 (Clarified) revised in February 2015.	Note 1
HKSA 230, *Audit Documentation*	Discard HKSA 230 revised in August 2015 and replace with the attached HKSA 230.	Note 2
HKSA 240 (Clarified), *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	Discard HKSA 240 (Clarified) revised in February 2015.	Note 1
HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	Replace pages 1-2, 4-9, 12, 14-18, 20, 24-26, 39-41 with revised pages 1-2, 4-9, 12, 14-18, 20, 24-26, 39-41.	Note 2
HKSA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements, Including Related Conforming Amendments to Other Hong Kong Standards*	Insert after HKSA 250 (Clarified) revised in July 2010.	Note 3
HKSA 260 (Clarified), *Communication with Those Charged with Governance*	Discard HKSA 260 (Clarified) revised in February 2015.	Note 1
HKSA 260 (Revised), *Communication with Those Charged with Governance*	Replace pages 1-2, 8-9, 12-13, 15-16, 21-22 with revised pages 1-2, 8-9, 12-13, 15-16, 21-22.	Note 2
HKSA 300 (Clarified), *Planning an Audit of Financial Statements*	Discard HKSA 300 (Clarified) revised in February 2015.	Note 1
HKSA 300, *Planning an Audit of Financial Statements*	Discard HKSA 300 revised in January 2016 and replace with the attached HKSA 300.	Note 2
HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	Discard HKSA 315 (Revised) revised in December 2012.	Note 1
HKSA 315 (Revised 2016), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	Discard HKSA 315 (Revised 2016) revised in January 2016 and replace with the attached HKSA 315 (Revised).	Note 2
HKSA 320 (Clarified), *Materiality in Planning and Performing an Audit*	Discard HKSA 320 (Clarified) revised in July 2010.	Note 1
HKSA 320, *Materiality in Planning and Performing an Audit*	Discard HKSA 320 revised in January 2016 and replace with the attached HKSA 320.	Note 2
HKSA 330 (Clarified), *The Auditor's Responses to Assessed Risks*	Discard HKSA 330 (Clarified) revised in December 2012.	Note 1

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HKSA 500 (Clarified), *Audit Evidence*	Discard HKSA 500 (Clarified) revised in February 2015.	Note 1
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HKSA 510 (Clarified), *Initial Audit Engagements—Opening Balances*	Discard HKSA 510 (Clarified) revised in June 2014.	Note 1
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HKSA 540 (Clarified), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*	Discard HKSA 540 (Clarified) revised in July 2010.	Note 1
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HKSA 560, *Subsequent Events*	Discard HKSA 560 revised in August 2015 and replace with the attached HKSA 560.	Note 2
HKSA 570 (Clarified), *Going Concern*	Discard HKSA 570 (Clarified) revised in July 2010.	Note 1
HKSA 570 (Revised), *Going Concern*	Replace pages 1-3, 5, 14, 16, 18-20 with revised pages 1-3, 5, 14, 16, 18-20.	Note 2
HKSA 580 (Clarified), *Written Representations*	Discard HKSA 580 (Clarified) revised in June 2014.	Note 1
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HKSA 600 (Clarified), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*	Discard HKSA 600 (Clarified) revised in February 2015.	Note 1
HKSA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*	Discard HKSA 600 revised in August 2015 and replace with the attached HKSA 600.	Note 2
HKSA 700 (Clarified), *Forming an Opinion and Reporting on Financial Statements*	Discard HKSA 700 (Clarified) revised in September 2014.	Note 1
HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*	Discard HKSA 700 (Revised) revised in August 2016 and replace with the attached HKSA 700 (Revised).	Note 2
HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*	Replace pages 1-2, 8, 19 with revised pages 1-2, 8, 19.	Note 2
HKSA 705 (Clarified), *Modifications to the Opinion in the Independent Auditor's Report*	Discard HKSA 705 (Clarified) revised in June 2014.	Note 1
HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*	Replace pages 1-3, 8-12, 15, 24-30 with revised pages 1-3, 8-12, 15, 24-30.	Note 2
HKSA 706 (Clarified), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	Discard HKSA 706 (Clarified) revised in June 2014.	Note 1
HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	Replace pages 1-3, 6, 8, 13, 16 with revised pages 1-3, 6, 8, 13, 16.	Note 2
HKSA 710 (Clarified), *Comparative Information—Corresponding Figures and Comparative Financial Statements*	Discard HKSA 710 (Clarified) revised in June 2014.	Note 1
HKSA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*	Discard HKSA 710 revised in August 2015 and replace with the attached HKSA 710.	Note 2
HKSA 720 (Clarified), *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*	Discard HKSA 720 (Clarified) revised in June 2014.	Note 1

HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*	Replace pages 1-2, 4, 10, 13, 21, 24, 27 with revised pages 1-2, 4, 10, 13, 21, 24, 27.	Note 2
HKSA 800 (Clarified), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*	Discard HKSA 800 (Clarified) revised in July 2010.	Note 1
HKSA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*	Replace pages 1-6, 8-10, 19-22 with revised pages 1-6, 8-10, 19-22.	Note 2
HKSA 805 (Clarified), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*	Discard HKSA 805 (Clarified) revised in July 2010.	Note 1
HKSA 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*	Discard HKSA 805 revised in August 2016 and replace with the attached HKSA 805.	Note 2
HKSA 810 (Clarified), *Engagements to Report on Summary Financial Statements*	Discard HKSA 810 (Clarified) revised in September 2014.	Note 1
HKSA 810 (Revised), *Engagements to Report on Summary Financial Statements*	Replace pages 1-2, 4-5, 11-12, 16 with revised pages 1-2, 4-5, 11-12, 16.	Note 2
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PN 600.1 (Revised), *Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)*	Discard PN 600.1 (Revised) issued in June 2014 and revised in December 2015.	Note 4
PN 810.2 (Revised), *The Duties of the Auditor of an Insurer authorized under the Insurance Companies Ordinance*	Discard PN 810.2 (Revised) issued in February 2015 and revised in February 2016.	- ditto -
PN 820 (Revised), *The Audit of Licensed Corporations and Associated Entities of Intermediaries*	Discard PN 820 (Revised) issued in December 2014 and revised in March 2016.	- ditto -
PN 900 (Revised), *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard*	Discard PN 900 (Revised) issued in September 2014.	- ditto -

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AG 3.340 *Prospectuses and the reporting accountant*	Discard AG 3.340 issued in October 1974 and revised in April 2014.	Note 5

Notes:

1. These clarified Hong Kong Standards on Auditing (HKSAs) are superseded by the revised HKSAs issued under the following Members' Handbook Updates which became effective on 15 December 2016:

   - Update No.172: http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/updates/update172.pdf

   - Update No. 180: http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/updates/update180.pdf

   - Update No. 188: http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/updates/update188.pdf

2. These revised HKSAs replace the clarified HKSAs superseded as mentioned in Note 1 above. The previous versions before these formatting changes can be found in the link: http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/handbook/2017tracks/prevmarkup.pdf. In this Update, these HKSAs are updated for editorial and formatting changes only.

3. HKSA 250 (Revised) is issued in response to the release of ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, *Including Related Conforming Amendments to Other International Standards* by the International Auditing and Assurance Board in October 2016. The revision is in respond to new requirements in the HKICPA *Code of Ethics for Professional Accountants* addressing non-compliance with laws and regulations, which will be effective on 15 July 2017.

   HKSA 250 (Revised) will be effective for audits of financial statements for periods beginning on or after 15 December 2017.

   In order for readers to easily identify the changes, a marked-up version of HKSA 250 (Revised) is posted at: http://www.hkicpa.org.hk/file/media/section6_standards/technical_resources/pdf-file/handbook/2017tracks/trackstds_250.pdf

4. These practice notes are superseded by the revised practice notes issued under the following Members' Handbook Updates which became effective on 15 December 2016:

   - Update No. 188: http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/updates/update188.pdf

- Update No. 190:
  http://app1.hkicpa.org.hk/hksaebk/HKSA_Members_Handbook_Master/updates/update190.pdf

5. AG 3.340 is superseded by HKSIR 200, *Accountants' Reports on Historical Financial Information in Investment Circulars* which is effective for engagements where the investment circular is dated on or after 1 July 2017.

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

MEMBERS' HANDBOOK
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(Updated to June 2017)

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HKSA 200
Issued June 2009; revised July 2010, May 2013, February 2015,
January 2016, June 2017

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

Hong Kong Standard on Auditing 200

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

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

HONG KONG STANDARD ON AUDITING 200

OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH HONG KONG STANDARDS ON AUDITING

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

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Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the independent auditor's overall responsibilities when conducting an audit of financial statements in accordance with HKSAs. Specifically, it sets out the overall objectives of the independent auditor, and explains the nature and scope of an audit designed to enable the independent auditor to meet those objectives. It also explains the scope, authority and structure of the HKSAs, and includes requirements establishing the general responsibilities of the independent auditor applicable in all audits, including the obligation to comply with the HKSAs. The independent auditor is referred to as "the auditor" hereafter.

2. HKSAs are written in the context of an audit of financial statements by an auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. HKSAs do not address the responsibilities of the auditor that may exist in legislation, regulation or otherwise in connection with, for example, the offering of securities to the public. Such responsibilities may differ from those established in the HKSAs. Accordingly, while the auditor may find aspects of the HKSAs helpful in such circumstances, it is the responsibility of the auditor to ensure compliance with all relevant legal, regulatory or professional obligations.

An Audit of Financial Statements

3. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with HKSAs and relevant ethical requirements enables the auditor to form that opinion. (Ref: Para. A1)

4. The financial statements subject to audit are those of the entity, prepared by management of the entity with oversight from those charged with governance. HKSAs do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with HKSAs is conducted on the premise that management and, where appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A2-A11)

5. As the basis for the auditor's opinion, HKSAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. (Ref: Para. A30-A54)

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

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

   - Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.

   - Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.

   - Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained.

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

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

Effective Date

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

Overall Objectives of the Auditor

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

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

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1 HKSA 320, *Materiality in Planning and Performing an Audit* and HKSA 450, *Evaluation of Misstatements Identified during the Audit*

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

(b) To report on the financial statements, and communicate as required by the HKSAs, in accordance with the auditor's findings.

12. In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the HKSAs require that the auditor disclaim an opinion or withdraw (or resign)[3] from the engagement, where withdrawal is possible under applicable law or regulation.

Definitions

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

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

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

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

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

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

(b) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and other information. For purposes of the HKSAs:

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

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

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

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[3] In the HKSAs, only the term "withdrawal" is used.

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

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

(f) Financial statements – A structured representation of historical financial information, including disclosures, intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with a financial reporting framework. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of a financial statement, or in the notes, or incorporated therein by cross-reference. (Ref: Para. A14-A15)

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

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

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

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

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

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

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

(iii) To provide the auditor with:

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

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

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

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

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

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

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

(m) Reasonable assurance – In the context of an audit of financial statements, a high, but not absolute, level of assurance.

(n) Risk of material misstatement – The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

(i) Inherent risk – 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.

(ii) Control risk – 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.

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

Requirements

Ethical Requirements Relating to an Audit of Financial Statements

14. The auditor shall comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. (Ref: Para. A16-A19)

Professional Skepticism

15. The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A20-A24)

Professional Judgment

16. The auditor shall exercise professional judgment in planning and performing an audit of financial statements. (Ref: Para. A25-A29)

Sufficient Appropriate Audit Evidence and Audit Risk

17. To obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. (Ref: Para. A30-A54)

Conduct of an Audit in Accordance with HKSAs

Complying with HKSAs Relevant to the Audit

18. The auditor shall comply with all HKSAs relevant to the audit. An HKSA is relevant to the audit when the HKSA is in effect and the circumstances addressed by the HKSA exist. (Ref: Para. A55-A59)

19. The auditor shall have an understanding of the entire text of an HKSA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly. (Ref: Para. A60-A68)

20. The auditor shall not represent compliance with HKSAs in the auditor's report unless the auditor has complied with the requirements of this HKSA and all other HKSAs relevant to the audit.

Objectives Stated in Individual HKSAs

21. To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant HKSAs in planning and performing the audit, having regard to the interrelationships among the HKSAs, to: (Ref: Para. A69-A71)

    (a) Determine whether any audit procedures in addition to those required by the HKSAs are necessary in pursuance of the objectives stated in the HKSAs; and (Ref: Para. A72)

    (b) Evaluate whether sufficient appropriate audit evidence has been obtained. (Ref: Para. A73)

Complying with Relevant Requirements

22. Subject to paragraph 23, the auditor shall comply with each requirement of an HKSA unless, in the circumstances of the audit:

    (a) The entire HKSA is not relevant; or

    (b) The requirement is not relevant because it is conditional and the condition does not exist. (Ref: Para. A74-A75)

23. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an HKSA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a relevant requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement. (Ref: Para. A76)

Failure to Achieve an Objective

24. If an objective in a relevant HKSA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor and thereby requires the auditor, in accordance with the HKSAs, to modify the auditor's opinion or withdraw from the engagement (where withdrawal is possible under applicable law or regulation). Failure to achieve an objective represents a significant matter requiring documentation in accordance with HKSA 230. [4] (Ref: Para. A77-A78)

Conformity and Compliance with International Standards on Auditing

25. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*. Compliance with the requirements of this HKSA ensures compliance with ISA 200.

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Application and Other Explanatory Material

An Audit of Financial Statements

Scope of the Audit (Ref: Para. 3)

A1. The auditor's opinion on the financial statements deals with whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Such an opinion is common to all audits of financial statements. The auditor's opinion therefore does not assure, for example, the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. In some jurisdictions, however, applicable law or regulation may require auditors to provide opinions on other specific matters, such as the effectiveness of internal control, or the consistency of a separate management report with the financial statements. While the HKSAs include requirements and guidance in relation to such matters to the extent that they are relevant to forming an opinion on the financial statements, the auditor would be required to undertake further work if the auditor had additional responsibilities to provide such opinions.

4 HKSA 230, *Audit Documentation*, paragraph 8(c)

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

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

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

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

(c) To provide the auditor with:

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

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

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

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

- The identification of the applicable financial reporting framework, in the context of any relevant laws or regulations.
- The preparation of the financial statements in accordance with that framework.
- The inclusion of an adequate description of that framework in the financial statements.

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

A4. The financial statements may be prepared in accordance with a financial reporting framework designed to meet:

- The common financial information needs of a wide range of users (that is, "general purpose financial statements"); or
- The financial information needs of specific users (that is, "special purpose financial statements").

A5. The applicable financial reporting framework often encompasses financial reporting standards established by an authorized or recognized standards setting organization, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorized or recognized standards setting organization and legislative or regulatory requirements. Other sources may provide direction on the application of the applicable financial reporting framework. In some cases, the applicable financial reporting framework may encompass such other sources, or may even consist only of such sources. Such other sources may include:

- The legal and ethical environment, including statutes, regulations, court decisions, and professional ethical obligations in relation to accounting matters;
- Published accounting interpretations of varying authority issued by standards setting, professional or regulatory organizations;
- Published views of varying authority on emerging accounting issues issued by standards setting, professional or regulatory organizations;
- General and industry practices widely recognized and prevalent; and
- Accounting literature.

Where conflicts exist between the financial reporting framework and the sources from which direction on its application may be obtained, or among the sources that encompass the financial reporting framework, the source with the highest authority prevails.

A6. The requirements of the applicable financial reporting framework determine the form and content of the financial statements. Although the framework may not specify how to account for or disclose all transactions or events, it ordinarily embodies sufficient broad principles that can serve as a basis for developing and applying accounting policies that are consistent with the concepts underlying the requirements of the framework.

A7. Some financial reporting frameworks are fair presentation frameworks, while others are compliance frameworks. Financial reporting frameworks that encompass primarily the financial reporting standards established by an organization that is authorized or recognized to promulgate standards to be used by entities for preparing general purpose financial statements are often designed to achieve fair presentation, for example, Hong Kong Financial Reporting Standards (HKFRSs) issued by the Hong Kong Institute of Certified Public Accountants (HKICPA).

A8. The requirements of the applicable financial reporting framework also determine what constitutes a complete set of financial statements. In the case of many frameworks, financial statements are intended to provide information about the financial position, financial performance and cash flows of an entity. For such frameworks, a complete set of financial statements would include a balance sheet; an income statement; a statement of changes in equity; a cash flow statement; and related notes. For some other financial reporting frameworks, a single financial statement and the related notes might constitute a complete set of financial statements:

- For example, the International Public Sector Accounting Standard (IPSAS), "Financial Reporting Under the Cash Basis of Accounting" issued by the International Public Sector Accounting Standards Board states that the primary financial statement is a statement of cash receipts and payments when a public sector entity prepares its financial statements in accordance with that IPSAS.

- Other examples of a single financial statement, each of which would include related notes, are:
    - Balance sheet.
    - Statement of income or statement of operations.
    - Statement of retained earnings.
    - Statement of cash flows.
    - Statement of assets and liabilities that does not include owner's equity.
    - Statement of changes in owners' equity.
    - Statement of revenue and expenses.
    - Statement of operations by product lines.

A9. HKSA 210 establishes requirements and provides guidance on determining the acceptability of the applicable financial reporting framework.[5] HKSA 800 deals with special considerations when financial statements are prepared in accordance with a special purpose framework.[6]

A10. Because of the significance of the premise to the conduct of an audit, the auditor is required to obtain the agreement of management and, where appropriate, those charged with governance that they acknowledge and understand that they have the responsibilities set out in paragraph A2 as a precondition for accepting the audit engagement.[7]

Considerations Specific to Audits in the Public Sector

A11. The mandates for audits of the financial statements of public sector entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of a public sector entity is conducted may include additional responsibilities, such as the responsibility for the execution of transactions and events in accordance with law, regulation or other authority.[8]

Form of the Auditor's Opinion (Ref: Para. 8)

A12. The opinion expressed by the auditor is on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. The form of the auditor's opinion, however, will depend upon the applicable financial reporting framework and any applicable law or regulation. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, *preparation* of the financial statements in accordance with the applicable financial reporting framework includes *presentation*.

A13. Where the financial reporting framework is a fair presentation framework, as is generally the case for general purpose financial statements, the opinion required by the HKSAs is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view. Where the financial reporting framework is a compliance framework, the opinion

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5 HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

6 HKSA 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 8

7 HKSA 210, paragraph 6(b)

8 See paragraph A59.

required is on whether the financial statements are prepared, in all material respects, in accordance with the framework. Unless specifically stated otherwise, references in the HKSAs to the auditor's opinion cover both forms of opinion.

Definitions

Financial Statements (Ref: Para. 13(f))

A14. Some financial reporting frameworks may refer to an entity's economic resources or obligations in other terms. For example, these may be referred to as the entity's assets and liabilities, and the residual difference between them may be referred to as equity or equity interests.

A15. Explanatory or descriptive information required to be included in the financial statements by the applicable financial reporting framework may be incorporated therein by cross-reference to information in another document, such as a management report or a risk report. "Incorporated therein by cross-reference" means cross-referenced from the financial statements to the other document, but not from the other document to the financial statements. Where the applicable financial reporting framework does not expressly prohibit the cross-referencing of where explanatory or descriptive information may be found, and the information has been appropriately cross-referenced, the information will form part of the financial statements.

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

A16. The auditor is subject to relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements. Relevant ethical requirements ordinarily comprise Parts A, B and D of the HKICPA's *Code of Ethics for Professional Accountants* (the Code) related to an audit of financial statements together with national requirements that are more restrictive.

A17. Part A of the Code establishes the fundamental principles of professional ethics relevant to the auditor when conducting an audit of financial statements and provides a conceptual framework for applying those principles. The fundamental principles with which the auditor is required to comply by the Code are:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

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

A18. In the case of an audit engagement it is in the public interest and, therefore, required by the Code, that the auditor be independent of the entity subject to the audit. The Code describes independence as comprising both independence of mind and independence in appearance. The auditor's independence from the entity safeguards the auditor's ability to form an audit opinion without being affected by influences that might compromise that opinion. Independence enhances the auditor's ability to act with integrity, to be objective and to maintain an attitude of professional skepticism.

A19. Hong Kong Standard on Quality Control (HKSQC) 1[9] deal with the firm's responsibilities to establish and maintain its system of quality control for audit engagements.[10] HKSQC 1 sets out the responsibilities of the firm for establishing policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, including those pertaining to independence.[11] HKSA 220 sets out the engagement partner's responsibilities with respect to relevant ethical requirements. These include remaining alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team, determining the appropriate action if matters come to the engagement partner's attention that indicate that members of the engagement team have not complied with relevant ethical requirements, and forming a conclusion on compliance with independence requirements that apply to the audit engagement.[12] HKSA 220 recognizes that the engagement team is entitled to rely on a firm's system of quality control in meeting its responsibilities with respect to quality control procedures applicable to the individual audit engagement, unless information provided by the firm or other parties suggests otherwise.

Professional Skepticism (Ref: Para. 15)

A20. Professional skepticism includes being alert to, for example:

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

A21. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of:

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

A22. Professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

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

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

11 HKSQC 1, paragraphs 20-25

12 HKSA 220, paragraphs 9-12

A23. The auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary. Nevertheless, the auditor is required to consider the reliability of information to be used as audit evidence.[13] In cases of doubt about the reliability of information or indications of possible fraud (for example, if conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document may have been falsified), the HKSAs require that the auditor investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter.[14]

A24. The auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance. Nevertheless, a belief that management and those charged with governance are honest and have integrity does not relieve the auditor of the need to maintain professional skepticism or allow the auditor to be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

Professional Judgment (Ref: Para. 16)

A25. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the HKSAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. Professional judgment is necessary in particular regarding decisions about:

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

A26. The distinguishing feature of the professional judgment expected of an auditor is that it is exercised by an auditor whose training, knowledge and experience have assisted in developing the necessary competencies to achieve reasonable judgments.

A27. The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor. Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, such as that required by HKSA 220,[15] assist the auditor in making informed and reasonable judgments.

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

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

[15] HKSA 220, paragraph 18

A28. Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

A29. Professional judgment needs to be exercised throughout the audit. It also needs to be appropriately documented. In this regard, the auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit.[16] Professional judgment is not to be used as the justification for decisions that are not otherwise supported by the facts and circumstances of the engagement or sufficient appropriate audit evidence.

Sufficient Appropriate Audit Evidence and Audit Risk (Ref: Para. 5 and 17)

Sufficiency and Appropriateness of Audit Evidence

A30. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit[17]) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared by an expert employed or engaged by the entity. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases, the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence.

A31. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A32. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A33. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. HKSA 500 and other relevant HKSAs establish additional requirements and provide further guidance applicable throughout the audit regarding the auditor's considerations in obtaining sufficient appropriate audit evidence.

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16 HKSA 230, paragraph 8

17 HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 9

Audit Risk

A34. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

A35. For purposes of the HKSAs, audit risk does not include the risk that the auditor might express an opinion that the financial statements are materially misstated when they are not. This risk is ordinarily insignificant. Further, audit risk is a technical term related to the process of auditing; it does not refer to the auditor's business risks such as loss from litigation, adverse publicity, or other events arising in connection with the audit of financial statements.

Risks of Material Misstatement

A36. The risks of material misstatement may exist at two levels:

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

A37. Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

A38. Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk. Auditors use various approaches to accomplish the objective of assessing the risks of material misstatement. For example, the auditor may make use of a model that expresses the general relationship of the components of audit risk in mathematical terms to arrive at an acceptable level of detection risk. Some auditors find such a model to be useful when planning audit procedures.

A39. The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

A40. Inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. For example, it may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement. Factors in the entity and its environment that relate to several or all of the classes of transactions, account balances, or disclosures may also influence the inherent risk related to a specific assertion. Such factors may include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

A41. Control risk is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements. However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of internal control. These include, for example, the possibility of human errors or mistakes, or of controls being circumvented by collusion or inappropriate management override. Accordingly, some control risk will always exist. The HKSAs provide the conditions under which the auditor is required to, or may choose to, test the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures to be performed.[18]

A42. The HKSAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.

A43. HKSA 315 (Revised) establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

Detection Risk

A44. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

A45. Detection risk relates to the nature, timing and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor. Matters such as:

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

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

A46. HKSA 300[19] and HKSA 330 establish requirements and provide guidance on planning an audit of financial statements and the auditor's responses to assessed risks. Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Inherent Limitations of an Audit

A47. The auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of

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

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

the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. The inherent limitations of an audit arise from:

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

The Nature of Financial Reporting

A48. The preparation of financial statements involves judgment by management in applying the requirements of the entity's applicable financial reporting framework to the facts and circumstances of the entity. In addition, many financial statement items involve subjective decisions or assessments or a degree of uncertainty, and there may be a range of acceptable interpretations or judgments that may be made. Consequently, some financial statement items are subject to an inherent level of variability which cannot be eliminated by the application of additional auditing procedures. For example, this is often the case with respect to certain accounting estimates. Nevertheless, the HKSAs require the auditor to give specific consideration to whether accounting estimates are reasonable in the context of the applicable financial reporting framework and related disclosures, and to the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments.[20]

The Nature of Audit Procedures

A49. There are practical and legal limitations on the auditor's ability to obtain audit evidence. For example:

- There is the possibility that management or others may not provide, intentionally or unintentionally, the complete information that is relevant to the preparation of the financial statements or that has been requested by the auditor. Accordingly, the auditor cannot be certain of the completeness of information, even though the auditor has performed audit procedures to obtain assurance that all relevant information has been obtained.
- Fraud may involve sophisticated and carefully organized schemes designed to conceal it. Therefore, audit procedures used to gather audit evidence may be ineffective for detecting an intentional misstatement that involves, for example, collusion to falsify documentation which may cause the auditor to believe that audit evidence is valid when it is not. The auditor is neither trained as nor expected to be an expert in the authentication of documents.
- An audit is not an official investigation into alleged wrongdoing. Accordingly, the auditor is not given specific legal powers, such as the power of search, which may be necessary for such an investigation.

Timeliness of Financial Reporting and the Balance between Benefit and Cost

A50. The matter of difficulty, time, or cost involved is not in itself a valid basis for the auditor to omit an audit procedure for which there is no alternative or to be satisfied with audit evidence that is less than persuasive. Appropriate planning assists in making sufficient time and resources

[20] HKSA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 12

available for the conduct of the audit. Notwithstanding this, the relevance of information, and thereby its value, tends to diminish over time, and there is a balance to be struck between the reliability of information and its cost. This is recognized in certain financial reporting frameworks (see, for example, the HKICPA's "Framework for the Preparation and Presentation of Financial Statements"). Therefore, there is an expectation by users of financial statements that the auditor will form an opinion on the financial statements within a reasonable period of time and at a reasonable cost, recognizing that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent until proved otherwise.

A51. Consequently, it is necessary for the auditor to:

- Plan the audit so that it will be performed in an effective manner;
- Direct audit effort to areas most expected to contain risks of material misstatement, whether due to fraud or error, with correspondingly less effort directed at other areas; and
- Use testing and other means of examining populations for misstatements.

A52. In light of the approaches described in paragraph A51, the HKSAs contain requirements for the planning and performance of the audit and require the auditor, among other things, to:

- Have a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels by performing risk assessment procedures and related activities;[21] and
- Use testing and other means of examining populations in a manner that provides a reasonable basis for the auditor to draw conclusions about the population.[22]

Other Matters that Affect the Inherent Limitations of an Audit

A53. In the case of certain assertions or subject matters, the potential effects of the inherent limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion. See HKSA 240 for further discussion.
- The existence and completeness of related party relationships and transactions. See HKSA 550[23] for further discussion.
- The occurrence of non-compliance with laws and regulations. See HKSA 250[24] for further discussion.
- Future events or conditions that may cause an entity to cease to continue as a going concern. See HKSA 570[25] for further discussion.

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[21] HKSA 315 (Revised), paragraphs 5-10

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

[23] HKSA 550, *Related Parties*

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

[25] HKSA 570 (Revised), *Going Concern*

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

A54. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with HKSAs. Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with HKSAs. However, the inherent limitations of an audit are not a justification for the auditor to be satisfied with less than persuasive audit evidence. Whether the auditor has performed an audit in accordance with HKSAs is determined by the audit procedures performed in the circumstances, the sufficiency and appropriateness of the audit evidence obtained as a result thereof and the suitability of the auditor's report based on an evaluation of that evidence in light of the overall objectives of the auditor.

Conduct of an Audit in Accordance with HKSAs

Nature of the HKSAs (Ref: Para. 18)

A55. The HKSAs, taken together, provide the standards for the auditor's work in fulfilling the overall objectives of the auditor. The HKSAs deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics.

A56. The scope, effective date and any specific limitation of the applicability of a specific HKSA is made clear in the HKSA. Unless otherwise stated in the HKSA, the auditor is permitted to apply an HKSA before the effective date specified therein.

A57. In performing an audit, the auditor may be required to comply with legal or regulatory requirements in addition to the HKSAs. The HKSAs do not override law or regulation that governs an audit of financial statements. In the event that such law or regulation differs from the HKSAs, an audit conducted only in accordance with law or regulation will not automatically comply with HKSAs.

A58. The auditor may also conduct the audit in accordance with both HKSAs and auditing standards of a specific jurisdiction or country. In such cases, in addition to complying with each of the HKSAs relevant to the audit, it may be necessary for the auditor to perform additional audit procedures in order to comply with the relevant standards of that jurisdiction or country.

Considerations Specific to Audits in the Public Sector

A59. The HKSAs are relevant to engagements in the public sector. The public sector auditor's responsibilities, however, may be affected by the audit mandate, or by obligations on public sector entities arising from law, regulation or other authority (such as ministerial directives, government policy requirements, or resolutions of the legislature), which may encompass a broader scope than an audit of financial statements in accordance with the HKSAs. These additional responsibilities are not dealt with in the HKSAs. They may be dealt with in the pronouncements of the International Organization of Supreme Audit Institutions or national standard setters, or in guidance developed by government audit agencies.

Contents of the HKSAs (Ref: Para. 19)

A60. In addition to objectives and requirements (requirements are expressed in the HKSAs using "shall"), an HKSA contains related guidance in the form of application and other explanatory material. It may also contain introductory material that provides context relevant to a proper understanding of the HKSA, and definitions. The entire text of an HKSA, therefore, is relevant to an understanding of the objectives stated in an HKSA and the proper application of the requirements of an HKSA.

A61. Where necessary, the application and other explanatory material provides further explanation of the requirements of an HKSA and guidance for carrying them out. In particular, it may:

- Explain more precisely what a requirement means or is intended to cover.
- Include examples of procedures that may be appropriate in the circumstances.

While such guidance does not in itself impose a requirement, it is relevant to the proper application of the requirements of an HKSA. The application and other explanatory material may also provide background information on matters addressed in an HKSA.

A62. Appendices form part of the application and other explanatory material. The purpose and intended use of an appendix are explained in the body of the related HKSA or within the title and introduction of the appendix itself.

A63. Introductory material may include, as needed, such matters as explanation of:

- The purpose and scope of the HKSA, including how the HKSA relates to other HKSAs.
- The subject matter of the HKSA.
- The respective responsibilities of the auditor and others in relation to the subject matter of the HKSA.
- The context in which the HKSA is set.

A64. An HKSA may include, in a separate section under the heading "Definitions," a description of the meanings attributed to certain terms for purposes of the HKSAs. These are provided to assist in the consistent application and interpretation of the HKSAs, and are not intended to override definitions that may be established for other purposes, whether in law, regulation or otherwise. Unless otherwise indicated, those terms will carry the same meanings throughout the HKSAs. The Glossary of Terms relating to Hong Kong Standards on Auditing and Quality Control issued by the HKICPA contains a complete listing of terms defined in the HKSAs. It also includes descriptions of other terms found in HKSAs to assist in common and consistent interpretation and translation.

A65. When appropriate, additional considerations specific to audits of smaller entities and public sector entities are included within the application and other explanatory material of an HKSA. These additional considerations assist in the application of the requirements of the HKSA in the audit of such entities. They do not, however, limit or reduce the responsibility of the auditor to apply and comply with the requirements of the HKSAs.

Considerations Specific to Smaller Entities

A66. For purposes of specifying additional considerations to audits of smaller entities, a "smaller entity" refers to an entity which typically possesses qualitative characteristics such as:

(a) Concentration of ownership and management in a small number of individuals (often a single individual – either a natural person or another enterprise that owns the entity provided the owner exhibits the relevant qualitative characteristics); and

(b) One or more of the following:

   (i) Straightforward or uncomplicated transactions;

   (ii) Simple record-keeping;

   (iii) Few lines of business and few products within business lines;

   (iv) Few internal controls;

   (v) Few levels of management with responsibility for a broad range of controls; or

   (vi) Few personnel, many having a wide range of duties.

These qualitative characteristics are not exhaustive, they are not exclusive to smaller entities, and smaller entities do not necessarily display all of these characteristics.

A67. The considerations specific to smaller entities included in the HKSAs have been developed primarily with unlisted entities in mind. Some of the considerations, however, may be helpful in audits of smaller listed entities.

A68. The HKSAs refer to the proprietor of a smaller entity who is involved in running the entity on a day-to-day basis as the "owner-manager."

Objectives Stated in Individual HKSAs (Ref: Para. 21)

A69. Each HKSA contains one or more objectives which provide a link between the requirements and the overall objectives of the auditor. The objectives in individual HKSAs serve to focus the auditor on the desired outcome of the HKSA, while being specific enough to assist the auditor in:

- Understanding what needs to be accomplished and, where necessary, the appropriate means of doing so; and
- Deciding whether more needs to be done to achieve them in the particular circumstances of the audit.

A70. Objectives are to be understood in the context of the overall objectives of the auditor stated in paragraph 11 of this HKSA. As with the overall objectives of the auditor, the ability to achieve an individual objective is equally subject to the inherent limitations of an audit.

A71. In using the objectives, the auditor is required to have regard to the interrelationships among the HKSAs. This is because, as indicated in paragraph A55, the HKSAs deal in some cases with general responsibilities and in others with the application of those responsibilities to specific topics. For example, this HKSA requires the auditor to adopt an attitude of professional skepticism; this is necessary in all aspects of planning and performing an audit but is not repeated as a requirement of each HKSA. At a more detailed level, HKSA 315 (Revised) and HKSA 330 contain, among other things, objectives and requirements that deal with the auditor's responsibilities to identify and assess the risks of material misstatement and to design and perform further audit procedures to respond to those assessed risks, respectively; these objectives and requirements apply throughout the audit. An HKSA dealing with specific aspects of the audit (for example, HKSA 540) may expand on how the objectives and requirements of such HKSAs as HKSA 315 (Revised) and HKSA 330 are to be applied in relation to the subject of the HKSA but does not repeat them. Thus, in achieving the objective stated in HKSA 540, the auditor has regard to the objectives and requirements of other relevant HKSAs.

Use of Objectives to Determine Need for Additional Audit Procedures (Ref: Para. 21(a))

A72. The requirements of the HKSAs are designed to enable the auditor to achieve the objectives specified in the HKSAs, and thereby the overall objectives of the auditor. The proper application of the requirements of the HKSAs by the auditor is therefore expected to provide a sufficient basis for the auditor's achievement of the objectives. However, because the circumstances of audit engagements vary widely and all such circumstances cannot be anticipated in the HKSAs, the auditor is responsible for determining the audit procedures necessary to fulfill the requirements of the HKSAs and to achieve the objectives. In the circumstances of an engagement, there may be particular matters that require the auditor to perform audit procedures in addition to those required by the HKSAs to meet the objectives specified in the HKSAs.

Use of Objectives to Evaluate Whether Sufficient Appropriate Audit Evidence Has Been Obtained (Ref: Para. 21(b))

A73. The auditor is required to use the objectives to evaluate whether sufficient appropriate audit evidence has been obtained in the context of the overall objectives of the auditor. If as a result the auditor concludes that the audit evidence is not sufficient and appropriate, then the auditor may follow one or more of the following approaches to meeting the requirement of paragraph 21(b):

- Evaluate whether further relevant audit evidence has been, or will be, obtained as a result of complying with other HKSAs;
- Extend the work performed in applying one or more requirements; or
- Perform other procedures judged by the auditor to be necessary in the circumstances.

Where none of the above is expected to be practical or possible in the circumstances, the auditor will not be able to obtain sufficient appropriate audit evidence and is required by the HKSAs to determine the effect on the auditor's report or on the auditor's ability to complete the engagement.

Complying with Relevant Requirements

Relevant Requirements (Ref: Para. 22)

A74. In some cases, an HKSA (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in HKSA 610 (Revised 2013)[26] is relevant.

A75. Within a relevant HKSA, there may be conditional requirements. Such a requirement is relevant when the circumstances envisioned in the requirement apply and the condition exists. In general, the conditionality of a requirement will either be explicit or implicit, for example:

- The requirement to modify the auditor's opinion if there is a limitation of scope[27] represents an explicit conditional requirement.

[26] HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 2

[27] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 13

- The requirement to communicate significant deficiencies in internal control identified during the audit to those charged with governance,[28] which depends on the existence of such identified significant deficiencies; and the requirement to obtain sufficient appropriate audit evidence regarding the presentation and disclosure of segment information in accordance with the applicable financial reporting framework,[29] which depends on that framework requiring or permitting such disclosure, represent implicit conditional requirements.

In some cases, a requirement may be expressed as being conditional on applicable law or regulation. For example, the auditor may be required to withdraw from the audit engagement, *where withdrawal is possible under applicable law or regulation*, or the auditor may be required to do something, *unless prohibited by law or regulation*. Depending on the jurisdiction, the legal or regulatory permission or prohibition may be explicit or implicit.

Departure from a Requirement (Ref: Para. 23)

A76. HKSA 230 establishes documentation requirements in those exceptional circumstances where the auditor departs from a relevant requirement.[30] The HKSAs do not call for compliance with a requirement that is not relevant in the circumstances of the audit.

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

A77. Whether an objective has been achieved is a matter for the auditor's professional judgment. That judgment takes account of the results of audit procedures performed in complying with the requirements of the HKSAs, and the auditor's evaluation of whether sufficient appropriate audit evidence has been obtained and whether more needs to be done in the particular circumstances of the audit to achieve the objectives stated in the HKSAs. Accordingly, circumstances that may give rise to a failure to achieve an objective include those that:

- Prevent the auditor from complying with the relevant requirements of an HKSA.

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

A78. Audit documentation that meets the requirements of HKSA 230 and the specific documentation requirements of other relevant HKSAs provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor. While it is unnecessary for the auditor to document separately (as in a checklist, for example) that individual objectives have been achieved, the documentation of a failure to achieve an objective assists the auditor's evaluation of whether such a failure has prevented the auditor from achieving the overall objectives of the auditor.

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[28] HKSA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph 9

[29] HKSA 501, *Audit Evidence—Specific Considerations for Selected Items*, paragraph 13

[30] HKSA 230, paragraph 12

HKSA 210

Issued June 2009; revised July, October 2010, December 2012, June 2014, August 2015, January 2016, August 2016, June 2017

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

Hong Kong Standard on Auditing 210

Agreeing the Terms of Audit Engagements

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

HONG KONG STANDARD ON AUDITING 210
AGREEING THE TERMS OF AUDIT ENGAGEMENTS

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

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Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities in agreeing the terms of the audit engagement with management and, where appropriate, those charged with governance. This includes establishing that certain preconditions for an audit, responsibility for which rests with management and, where appropriate, those charged with governance, are present. HKSA 220[1] deals with those aspects of engagement acceptance that are within the control of the auditor. (Ref: Para. A1)

Effective Date

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

Objective

3. The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through:

    (a) Establishing whether the preconditions for an audit are present; and

    (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Definitions

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

    Preconditions for an audit – The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise[2] on which an audit is conducted.

5. For the purposes of this HKSA, references to "management" should be read hereafter as "management and, where appropriate, those charged with governance."

Requirements

Preconditions for an Audit

6. In order to establish whether the preconditions for an audit are present, the auditor shall:

    (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A10)

    (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para. A11-A14, A21)

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[1] HKSA 220, *Quality Control for an Audit of Financial Statements*

[2] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 13

(i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A15)

(ii) For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and (Ref: Para. A16-A19)

(iii) To provide the auditor with:

a. Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

b. Additional information that the auditor may request from management for the purpose of the audit; and

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

Limitation on Scope Prior to Audit Engagement Acceptance

7. If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.

Other Factors Affecting Audit Engagement Acceptance

8. If the preconditions for an audit are not present, the auditor shall discuss the matter with management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

(a) If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable, except as provided in paragraph 19; or

(b) If the agreement referred to in paragraph 6(b) has not been obtained.

Agreement on Audit Engagement Terms

9. The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A22)

10. Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter[2a] or other suitable form of written agreement and shall include: (Ref: Para. A23-A27)

(a) The objective and scope of the audit of the financial statements;

(b) The responsibilities of the auditor;

[2a] Under the Corporate Practices (Registration) Rules of the HKICPA, the engagement letter for a corporate practice shall identify the director appointed by the corporate practice to be responsible for the performance of the audit engagement contemplated by the audit report.

(c) The responsibilities of management[2b];

(d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(e) Reference to the expected form and content of any reports to be issued by the auditor; and (Ref: Para. A24)

(f) A statement that there may be circumstances in which a report may differ from its expected form and content.

11. If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A23, A28-A29)

12. If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A28)

Recurring Audits

13. On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A30)

Acceptance of a Change in the Terms of the Audit Engagement

14. The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A31-A33)

15. If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A34-A35)

16. If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.

17. If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall:

(a) Withdraw from the audit engagement where possible under applicable law or regulation; and

(b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators[2c].

[2b] Under the Companies Ordinance, directors are responsible for the preparation of financial statements showing a true and fair view.

[2c] Auditor of a company incorporated under the Companies Ordinance who resigns or is removed from the office as auditor or where the auditor's term of office expires and not reappointed is required to comply with the requirements of sections 424 or 425 of the Companies Ordinance regarding the statement to be made by the auditor in relation to the resignation, removal or retirement.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation

18. If financial reporting standards established by an authorized or recognized standards setting organization are supplemented by law or regulation, the auditor shall determine whether there are any conflicts between the financial reporting standards and the additional requirements. If such conflicts exist, the auditor shall discuss with management the nature of the additional requirements and shall agree whether:

    (a) The additional requirements can be met through additional disclosures in the financial statements; or

    (b) The description of the applicable financial reporting framework in the financial statements can be amended accordingly.

    If neither of the above actions is possible, the auditor shall determine whether it will be necessary to modify the auditor's opinion in accordance with HKSA 705 (Revised).[3] (Ref: Para. A36)

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance

19. If the auditor has determined that the financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation, the auditor shall accept the audit engagement only if the following conditions are present: (Ref: Para. A37)

    (a) Management agrees to provide additional disclosures in the financial statements required to avoid the financial statements being misleading; and

    (b) It is recognized in the terms of the audit engagement that:

        (i) The auditor's report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures, in accordance with HKSA 706 (Revised);[4] and

        (ii) Unless the auditor is required by law or regulation to express the auditor's opinion on the financial statements by using the phrases "present fairly, in all material respects," or "give a true and fair view" in accordance with the applicable financial reporting framework, the auditor's opinion on the financial statements will not include such phrases.

20. If the conditions outlined in paragraph 19 are not present and the auditor is required by law or regulation to undertake the audit engagement, the auditor shall:

    (a) Evaluate the effect of the misleading nature of the financial statements on the auditor's report; and

    (b) Include appropriate reference to this matter in the terms of the audit engagement.

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[3] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

[4] HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

Auditor's Report Prescribed by Law or Regulation

21. In some cases, law or regulation of the relevant jurisdiction prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of HKSAs. In these circumstances, the auditor shall evaluate:

    (a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,

    (b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.[5]

    If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor shall not accept the audit engagement, unless required by law or regulation to do so. An audit conducted in accordance with such law or regulation does not comply with HKSAs. Accordingly, the auditor shall not include any reference within the auditor's report to the audit having been conducted in accordance with HKSAs.[6] (Ref: Para. A38-A39)

Conformity and Compliance with International Standards on Auditing

22. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 210 *Agreeing the Terms of Audit Engagements*. Compliance with the requirements of this HKSA ensures compliance with ISA 210.

23. Additional local guidance and explanations are provided in footnotes 2a, 2b and 2c. An example audit engagement letter is provided in Appendix 1.

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Application and Other Explanatory Material

Scope of this HKSA (Ref: Para. 1)

A1. Assurance engagements, which include audit engagements, may only be accepted when the practitioner considers that relevant ethical requirements such as independence and professional competence will be satisfied, and when the engagement exhibits certain characteristics.[7] The auditor's responsibilities in respect of ethical requirements in the context of the acceptance of an audit engagement and in so far as they are within the control of the auditor are dealt with in HKSA 220.[8] This HKSA deals with those matters (or preconditions) that are within the control of the entity and upon which it is necessary for the auditor and the entity's management to agree.

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5 HKSA 706 (Revised)

6 See also HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 43.

7 *Hong Kong Framework for Assurance Engagements*, paragraph 17

8 HKSA 220, paragraphs 9-11

Preconditions for an Audit

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

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

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

Determining the Acceptability of the Financial Reporting Framework

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

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

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

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

[9] *Hong Kong Framework for Assurance Engagements*, paragraph 19(b)(ii)

[10] HKSA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 8

A7. Deficiencies in the applicable financial reporting framework that indicate that the framework is not acceptable may be encountered after the audit engagement has been accepted. When use of that framework is prescribed by law or regulation, the requirements of paragraphs 19-20 apply. When use of that framework is not prescribed by law or regulation, management may decide to adopt another framework that is acceptable. When management does so, as required by paragraph 16, new terms of the audit engagement are agreed to reflect the change in the framework as the previously agreed terms will no longer be accurate.

General purpose frameworks

A8. At present, there is no objective and authoritative basis that has been generally recognized globally for judging the acceptability of general purpose frameworks. In the absence of such a basis, financial reporting standards established by organizations that are authorized or recognized to promulgate standards to be used by certain types of entities are presumed to be acceptable for general purpose financial statements prepared by such entities, provided the organizations follow an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders. Examples of such financial reporting standards include:

- International/ Hong Kong Financial Reporting Standards (IFRSs/ HKFRSs) promulgated by the International Accounting Standards Board/ the Hong Kong Institute of Certified Public Accountants;

- International Public Sector Accounting Standards (IPSASs) promulgated by the International Public Sector Accounting Standards Board; and

- Accounting principles promulgated by an authorized or recognized standards setting organization in a particular jurisdiction, provided the organization follows an established and transparent process involving deliberation and consideration of the views of a wide range of stakeholders.

These financial reporting standards are often identified as the applicable financial reporting framework in law or regulation governing the preparation of general purpose financial statements.

Financial reporting frameworks prescribed by law or regulation

A9. In accordance with paragraph 6(a), the auditor is required to determine whether the financial reporting framework, to be applied in the preparation of the financial statements, is acceptable. In some jurisdictions, law or regulation may prescribe the financial reporting framework to be used in the preparation of general purpose financial statements for certain types of entities. In the absence of indications to the contrary, such a financial reporting framework is presumed to be acceptable for general purpose financial statements prepared by such entities. In the event that the framework is not considered to be acceptable, paragraphs 19-20 apply.

Jurisdictions that do not have standards setting organizations or prescribed financial reporting frameworks

A10. When an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, or where use of the financial reporting framework is not prescribed by law or regulation, management identifies a financial reporting framework to be applied in the preparation of the financial statements. Appendix 2 contains guidance on determining the acceptability of financial reporting frameworks in such circumstances.

Agreement of the Responsibilities of Management (Ref: Para. 6(b))

A11. An audit in accordance with HKSAs is conducted on the premise that management has acknowledged and understands that it has the responsibilities set out in paragraph 6(b).[11] In certain jurisdictions, such responsibilities may be specified in law or regulation. In others, there may be little or no legal or regulatory definition of such responsibilities. HKSAs do not override law or regulation in such matters. However, the concept of an independent audit requires that the auditor's role does not involve taking responsibility for the preparation of the financial statements or for the entity's related internal control, and that the auditor has a reasonable expectation of obtaining the information necessary for the audit (including information obtained from outside of the general and subsidiary ledgers) in so far as management is able to provide or procure it. Accordingly, the premise is fundamental to the conduct of an independent audit. To avoid misunderstanding, agreement is reached with management that it acknowledges and understands that it has such responsibilities as part of agreeing and recording the terms of the audit engagement in paragraphs 9-12.

A12. The way in which the responsibilities for financial reporting are divided between management and those charged with governance will vary according to the resources and structure of the entity and any relevant law or regulation, and the respective roles of management and those charged with governance within the entity. In most cases, management is responsible for execution while those charged with governance have oversight of management. In some cases, those charged with governance will have, or will assume, responsibility for approving the financial statements or monitoring the entity's internal control related to financial reporting. In larger or public entities, a subgroup of those charged with governance, such as an audit committee, may be charged with certain oversight responsibilities.

A13. HKSA 580 requires the auditor to request management to provide written representations that it has fulfilled certain of its responsibilities.[12] It may therefore be appropriate to make management aware that receipt of such written representations will be expected, together with written representations required by other HKSAs and, where necessary, written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements.

A14. Where management will not acknowledge its responsibilities, or agree to provide the written representations, the auditor will be unable to obtain sufficient appropriate audit evidence.[13] In such circumstances, it would not be appropriate for the auditor to accept the audit engagement, unless law or regulation requires the auditor to do so. In cases where the auditor is required to accept the audit engagement, the auditor may need to explain to management the importance of these matters, and the implications for the auditor's report.

Preparation of the Financial Statements (Ref: Para. 6(b)(i))

A15. Most financial reporting frameworks include requirements relating to the presentation of the financial statements; for such frameworks, *preparation* of the financial statements in accordance with the financial reporting framework includes *presentation*. In the case of a fair presentation framework the importance of the reporting objective of fair presentation is such that the premise agreed with management includes specific reference to fair presentation, or to the responsibility to ensure that the financial statements will "give a true and fair view" in accordance with the financial reporting framework.

11 HKSA 200, paragraph A4

12 HKSA 580, *Written Representations*, paragraphs 10-11

13 HKSA 580, paragraph A26

Internal Control (Ref: Para. 6(b)(ii))

A16. Management maintains such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives due to the inherent limitations of internal control.[14]

A17. An independent audit conducted in accordance with the HKSAs does not act as a substitute for the maintenance of internal control necessary for the preparation of financial statements by management. Accordingly, the auditor is required to obtain the agreement of management that it acknowledges and understands its responsibility for internal control. However, the agreement required by paragraph 6(b)(ii) does not imply that the auditor will find that internal control maintained by management has achieved its purpose or will be free of deficiencies.

A18. It is for management to determine what internal control is necessary to enable the preparation of the financial statements. The term "internal control" encompasses a wide range of activities within components that may be described as the control environment; the entity's risk assessment process; the information system, including the related business processes relevant to financial reporting, and communication; control activities; and monitoring of controls. This division, however, does not necessarily reflect how a particular entity may design, implement and maintain its internal control, or how it may classify any particular component.[15] An entity's internal control (in particular, its accounting books and records, or accounting systems) will reflect the needs of management, the complexity of the business, the nature of the risks to which the entity is subject, and relevant laws or regulation.

A19. In some jurisdictions, law or regulation may refer to the responsibility of management for the adequacy of accounting books and records, or accounting systems. In some cases, general practice may assume a distinction between accounting books and records or accounting systems on the one hand, and internal control or controls on the other. As accounting books and records, or accounting systems, are an integral part of internal control as referred to in paragraph A18, no specific reference is made to them in paragraph 6(b)(ii) for the description of the responsibility of management. To avoid misunderstanding, it may be appropriate for the auditor to explain to management the scope of this responsibility.

Additional Information (Ref: Para. 6(b)(iii)b.)

A20. Additional information that the auditor may request from management for the purpose of the audit may include when applicable, matters related to other information in accordance with HKSA 720 (Revised). When the auditor expects to obtain other information after the date of the auditor's report, the terms of the audit engagement may also acknowledge the auditor's responsibilities relating to such other information including, if applicable, the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists in other information obtained after the date of the auditor's report.

Considerations Relevant to Smaller Entities (Ref: Para. 6(b))

A21. One of the purposes of agreeing the terms of the audit engagement is to avoid misunderstanding about the respective responsibilities of management and the auditor. For example, when a third party has assisted with the preparation of the financial statements, it

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[14] HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph A54

[15] HKSA 315 (Revised), paragraph A59 and Appendix 1

may be useful to remind management that the preparation of the financial statements in accordance with the applicable financial reporting framework remains its responsibility.

Agreement on Audit Engagement Terms

Agreeing the Terms of the Audit Engagement (Ref: Para. 9)

A22. The roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

Audit Engagement Letter or Other Form of Written Agreement[16] (Ref: Para. 10-11)

A23. It is in the interests of both the entity and the auditor that the auditor sends an audit engagement letter before the commencement of the audit to help avoid misunderstandings with respect to the audit. In some countries, however, the objective and scope of an audit and the responsibilities of management and of the auditor may be sufficiently established by law, that is, they prescribe the matters described in paragraph 10. Although in these circumstances paragraph 11 permits the auditor to include in the engagement letter only reference to the fact that relevant law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b), the auditor may nevertheless consider it appropriate to include the matters described in paragraph 10 in an engagement letter for the information of management.

Form and Content of the Audit Engagement Letter

A24. The form and content of the audit engagement letter may vary for each entity. Information included in the audit engagement letter on the auditor's responsibilities may be based on HKSA 200.[17] Paragraphs 6(b) and 12 of this HKSA deal with the description of the responsibilities of management. In addition to including the matters required by paragraph 10, an audit engagement letter may make reference to, for example:

- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, HKSAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.

- The form of any other communication of results of the audit engagement.

- The requirement for the auditor to communicate key audit matters in the auditor's report in accordance with HKSA 701.[18]

- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with HKSAs.

- Arrangements regarding the planning and performance of the audit, including the composition of the engagement team.

- The expectation that management will provide written representations (see also paragraph A13).

[16] In the paragraphs that follow, any reference to an audit engagement letter is to be taken as a reference to an audit engagement letter or other suitable form of written agreement.

[17] HKSA 200, paragraphs 3-9

[18] HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

- The expectation that management will provide access to all information of which management is aware that is relevant to the preparation of the financial statements, including an expectation that management will provide access to information relevant to disclosures.

- The agreement of management to make available to the auditor draft financial statements, including all information relevant to their preparation, whether obtained from within or outside of the general and subsidiary ledgers (including all information relevant to the preparation of disclosures), and the other information[19], if any, in time to allow the auditor to complete the audit in accordance with the proposed timetable.

- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.

- The basis on which fees are computed and any billing arrangements.

- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.

A25. When the auditor is not required to communicate key audit matters, it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

A26. When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.

- Arrangements concerning the involvement of internal auditors and other staff of the entity.

- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.

- Any restriction of the auditor's liability when such possibility exists.

- A reference to any further agreements between the auditor and the entity.

- Any obligations to provide audit working papers to other parties.

An example of an audit engagement letter is set out in Appendix 1.

Audits of Components

A27. When the auditor of a parent entity is also the auditor of a component, the factors that may influence the decision whether to send a separate audit engagement letter to the component include the following:

- Who appoints the component auditor;

- Whether a separate auditor's report is to be issued on the component;

[19] As defined in HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

- Legal requirements in relation to audit appointments;
- Degree of ownership by parent; and
- Degree of independence of the component management from the parent entity.

Responsibilities of Management Prescribed by Law or Regulation (Ref: Para. 11-12)

A28. If, in the circumstances described in paragraphs A23 and A29, the auditor concludes that it is not necessary to record certain terms of the audit engagement in an audit engagement letter, the auditor is still required by paragraph 11 to seek the written agreement from management that it acknowledges and understands that it has the responsibilities set out in paragraph 6(b). However, in accordance with paragraph 12, such written agreement may use the wording of the law or regulation if such law or regulation establishes responsibilities for management that are equivalent in effect to those described in paragraph 6(b). The accounting profession, audit standards setter, or audit regulator in a jurisdiction may have provided guidance as to whether the description in law or regulation is equivalent.

Considerations specific to public sector entities

A29. Law or regulation governing the operations of public sector audits generally mandate the appointment of a public sector auditor and commonly set out the public sector auditor's responsibilities and powers, including the power to access an entity's records and other information. When law or regulation prescribes in sufficient detail the terms of the audit engagement, the public sector auditor may nonetheless consider that there are benefits in issuing a fuller audit engagement letter than permitted by paragraph 11.

Recurring Audits (Ref: Para. 13)

A30. The auditor may decide not to send a new audit engagement letter or other written agreement each period. However, the following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

- Any indication that the entity misunderstands the objective and scope of the audit.
- Any revised or special terms of the audit engagement.
- A recent change of senior management.
- A significant change in ownership.
- A significant change in nature or size of the entity's business.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

Acceptance of a Change in the Terms of the Audit Engagement

Request to Change the Terms of the Audit Engagement (Ref: Para. 14)

A31. A request from the entity for the auditor to change the terms of the audit engagement may result from a change in circumstances affecting the need for the service, a misunderstanding as to the nature of an audit as originally requested or a restriction on the scope of the audit engagement, whether imposed by management or caused by other circumstances. The auditor, as required by paragraph 14, considers the justification given for the request, particularly the implications of a restriction on the scope of the audit engagement.

A32. A change in circumstances that affects the entity's requirements or a misunderstanding concerning the nature of the service originally requested may be considered a reasonable basis for requesting a change in the audit engagement.

A33. In contrast, a change may not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

Request to Change to a Review or a Related Service (Ref: Para. 15)

A34. Before agreeing to change an audit engagement to a review or a related service, an auditor who was engaged to perform an audit in accordance with HKSAs may need to assess, in addition to the matters referred to in paragraphs A31-A33 above, any legal or contractual implications of the change.

A35. If the auditor concludes that there is reasonable justification to change the audit engagement to a review or a related service, the audit work performed to the date of change may be relevant to the changed engagement; however, the work required to be performed and the report to be issued would be those appropriate to the revised engagement. In order to avoid confusing the reader, the report on the related service would not include reference to:

(a) The original audit engagement; or

(b) Any procedures that may have been performed in the original audit engagement, except where the audit engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

Additional Considerations in Engagement Acceptance

Financial Reporting Standards Supplemented by Law or Regulation (Ref: Para. 18)

A36. In some jurisdictions, law or regulation may supplement the financial reporting standards established by an authorized or recognized standards setting organization with additional requirements relating to the preparation of financial statements. In those jurisdictions, the applicable financial reporting framework for the purposes of applying the HKSAs encompasses both the identified financial reporting framework and such additional requirements provided they do not conflict with the identified financial reporting framework. This may, for example, be the case when law or regulation prescribes disclosures in addition to those required by the financial reporting standards or when they narrow the range of acceptable choices that can be made within the financial reporting standards.[20]

Financial Reporting Framework Prescribed by Law or Regulation—Other Matters Affecting Acceptance (Ref: Para. 19)

A37. Law or regulation may prescribe that the wording of the auditor's opinion use the phrases "present fairly, in all material respects" or "give a true and fair view" in a case where the auditor concludes that the applicable financial reporting framework prescribed by law or regulation would otherwise have been unacceptable. In this case, the terms of the prescribed wording of the auditor's report are significantly different from the requirements of HKSAs (see paragraph 21).

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 21)

A38. HKSAs require that the auditor shall not represent compliance with HKSAs unless the auditor has complied with all of the HKSAs relevant to the audit.[21] When law or regulation prescribes the layout or wording of the auditor's report in a form or in terms that are significantly different from the requirements of HKSAs and the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, the auditor may consider including a statement in the auditor's report that the audit is not conducted in accordance with HKSAs. The auditor is, however, encouraged to apply HKSAs, including the HKSAs that address the auditor's report, to the extent practicable, notwithstanding that the auditor is not permitted to refer to the audit being conducted in accordance with HKSAs.

Considerations Specific to Public Sector Entities

A39. In the public sector, specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister, the legislature or the public if the entity attempts to limit the scope of the audit.

[20] HKSA 700 (Revised), paragraph 15, includes a requirement regarding the evaluation of whether the financial statements adequately refer to or describe the applicable financial reporting framework.

[21] HKSA 200, paragraph 20

Appendix 1

Example of an Audit Engagement Letter

The following is an example of an audit engagement letter for an audit of general purpose financial statements of a company which is incorporated in Hong Kong under the Companies Ordinance but do not take advantage of the reporting exemption in the Companies Ordinance. This letter is not authoritative but is intended only to be a guide that may be used in conjunction with the considerations outlined in this HKSA. It will need to be varied according to individual requirements and circumstances, for example to the special reporting requirements of regulated entities. It may be appropriate to seek legal advice that any proposed letter is suitable.

To the directors of [ABC Company Limited]:

Objective of services

1.1 You have requested that we audit the (consolidated)* financial statements of ABC Company Limited ("the Company") (and its subsidiaries)*. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.

1.2 The objectives of our audit are to obtain reasonable assurance about whether the (consolidated)* financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Hong Kong Standards on Auditing ("HKSAs") will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these (consolidated)* financial statements.

Responsibilities of directors

2.1 Our audit will be conducted on the basis that you acknowledge and understand that you have responsibility:

a. To prepare (consolidated)* financial statements which give a true and fair view of the financial position of the Company (and its subsidiaries)* as at the end of the financial year and of [its][their] financial performance for the financial year in accordance with [*insert applicable financial reporting framework*] [*Hong Kong Financial Reporting Standards*][*Hong Kong Financial Reporting Standard for Private Entities*] and the Companies Ordinance ("CO");

b. (To ensure the subsidiary, if any, of the Company keeps accounting records that are sufficient for the Company to prepare (consolidated)* financial statements that comply with a. above.)*

c. To take all reasonable steps to ensure the Company keeps sufficient accounting records which show and explain the transactions of the Company (and its subsidiaries)*, disclose with reasonable accuracy, at any time, the financial position and financial performance of the Company (and its subsidiaries)*;

d. To ensure that the (consolidated)* financial statements comply with section 383 (Notes to Financial Statements to Contain Information on Directors' Emoluments etc) of the CO which must contain in the notes to the financial statements, the information prescribed by the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G);

e. For such internal control as you determine is necessary to enable the preparation of (consolidated)* financial statements that are free from material misstatement, whether due to fraud or error;

f. To provide us with[1]:

(i) Access to all information of which you are aware that is relevant to the preparation of the (consolidated)* financial statements such as Company's accounting records and all other relevant records and documentation, including minutes of all management and shareholders' meetings and other matters;

(ii) Additional information that we may request from you for the purpose of the audit; and

(iii) Unrestricted access to persons related to the Company (and its subsidiaries)* from whom we determine it necessary to obtain audit evidence;

g. To provide us with (i) any proposed written resolution and (ii) any other document relating to the resolution that is required to be sent to a member of the Company, on or before the circulation of written resolution to a member of the Company; and

h. To notify us any passed written resolution within 15 days after resolution is passed.

2.2 You are also responsible for the preparation and approval of the directors' report in accordance with the CO [as well as the other information included in the annual report] [#].

Responsibilities of the auditor

3.1 We have a statutory responsibility to prepare a report to the members to state whether in our opinion the (consolidated)* financial statements give a true and fair view of the financial position and financial performance of the Company (and its subsidiaries)* for the financial year and whether they have been properly prepared in compliance with the CO. We shall also state our opinion in the auditor's report if we are of the opinion that:

a. adequate accounting records have not been kept by the Company (and its subsidiaries)*; or

b. the (consolidated)* financial statements are not in agreement with the accounting records in any material respect; and

We shall also state the fact in the auditor's report if we have failed to obtain all the information or explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

In addition, where the (consolidated)* financial statements do not contain information on directors' emoluments, etc under section 383(1) of the CO, the CO requires us to include in our report, as far as we are reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the (consolidated)* financial statements.

1 See paragraph A24 for examples of other matters relating to management's responsibilities that may be included.

3.2 We have a professional responsibility to report if the (consolidated)* financial statements do not comply in any material respect with [*insert applicable financial reporting framework*] [*Hong Kong Financial Reporting Standards*][*Hong Kong Financial Reporting Standard for Private Entities*], unless in our opinion the noncompliance is justified in the circumstances. In determining whether or not the departure is justified, we consider:

a. whether the departure is required in order for the (consolidated)* financial statements to give a true and fair view; and

b. whether adequate disclosure has been made concerning the departure.

3.3 We are required to read the information in the directors' report for the financial year to identify and report inconsistencies with the (consolidated)* financial statements. As required by the CO, if we are of the opinion that the information in the directors' report for a financial year is not consistent with the (consolidated)* financial statements for the financial year, we shall state that opinion in our auditor's report; and we may bring that opinion to the members' attention at a general meeting. However, we are not required to audit or review the director's report and accordingly we will not express an opinion or review conclusion or any assurance on it.

[3.4 We are required to read the other information included in the annual report. This responsibility applies regardless of whether the other information is made available to us prior to, or after, the date of the auditor's report. We will consider whether the other information is materially inconsistent with the (consolidated)* financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is an uncorrected material misstatement of this other information, we are required to include that fact in the auditor's report. Our opinion on the (consolidated)* financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon. If we conclude that a material misstatement exists in other information obtained after the date of the auditor's report and the other information is not corrected after communicating with those charged with governance, we will take appropriate actions considering our legal rights and obligations.] #

Scope of audit

4.1 Our audit will be conducted in accordance with HKSAs issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements. As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

a. Identify and assess the risks of material misstatement of the (consolidated)* financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

b. Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[2] However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the (consolidated)* financial statements that we have

[2] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

identified during the audit. Any such report may not be provided to third parties without our prior written consent. Such consent will be granted only on the basis that such reports are not prepared with the interests of anyone other than the Company in mind and that we accept no duty or responsibility to any other party as concerns the reports.

c. Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by you.

d. Conclude on the appropriateness of your use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

e. Evaluate the overall presentation, structure and content of the (consolidated)* financial statements, including the disclosures, and whether the (consolidated)* financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

4.2 Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with HKSAs.

(4.3 In connection with the audit of the consolidated financial statements, we draw your attention to section 412 of the CO which gives the rights to the auditor of the holding company to require a person that is a related entity of the company to provide any information or explanation that the auditor reasonably requires for the performance of the duties as auditor of the holding company. As defined in section 412 of the CO, a related entity includes an auditor of a subsidiary undertaking.

4.4 In order to express an opinion on the consolidated financial statements which include the financial information of subsidiaries, joint arrangements or associates of which we are not the auditor, it will be necessary for us to communicate directly with the other auditor(s) concerned to satisfy ourselves that:

a. so far as is practicable, there is uniformity within the Company and its subsidiaries in the application of accounting policies;

b. the consolidated financial statements contain the information required by the CO, applicable accounting standards and any other legislation or non-statutory requirements affecting the presentation of financial statements; and

c. all material aspects of the consolidated financial statements have been subjected to an audit, the nature and extent of which is adequate and reasonable, in our view, for the purpose of forming an opinion on the consolidated financial statements.)*

4.5 As part of our audit procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the audit in connection with the audit. In connection with representations and the supply of information to us generally, we draw your attention to section 412 of the CO which sets out the rights of the auditor in relation to obtaining information from a person that is a related entity as defined in this section of the CO. You are also referred to section 413 of the CO which sets out the offences relating to section 412 of the CO.

4.6 In order to assist us with the audit of your (consolidated)* financial statements, we shall request sight of all documents or statements, including the chairman's statement, operating and financial review and the directors' report, which are due to be issued with the (consolidated)* financial statements. We are also entitled to attend all general meetings of the Company and to receive notice of all such meetings.

4.7 The responsibility for safeguarding the assets of the Company (and its subsidiaries)* and for the prevention and detection of fraud, error and non-compliance with law or regulations rests with you. However, we shall endeavour to plan our audit so that we have a reasonable expectation of detecting material misstatements in the (consolidated)* financial statements or books of account (including those resulting from fraud, error or non-compliance with law or regulations), but our audit should not be relied upon to disclose all such material misstatements or frauds, errors or instances of non-compliance as may exist.

4.8 (Where appropriate - Note) We shall not be treated as having notice, for the purposes of our audit responsibilities, of information provided to members of our firm other than those engaged on the audit (for example information provided in connection with accounting, taxation and other services).

4.9 Once we have issued our report we have no further direct responsibility in relation to the (consolidated)* financial statements for that period. However, you agree that you will inform us of any material event occurring between the date of our report and that of the Annual General Meeting which may affect the (consolidated)* financial statements.

Reporting

5.1 [*Insert appropriate reference to the expected form and content of the auditor's report including, if applicable, the reporting on other information in accordance with HKSA 720 (Revised).*]

5.2 The form and content of our report may need to be amended in the light of our audit findings.

(Other services

6. You have requested that we provide other services in respect of ...... The terms under which we provide these other services are dealt with in a separate letter.)*

Fees

7. Our fees are computed on the basis of the time spent on your affairs by our partners and our staff and on the levels of skill and responsibility involved plus out-of-pocket expenses. Unless otherwise agreed, our fees will be billed at appropriate intervals during the course of the audit and will be due on presentation.

Agreement of terms

8.1 Once it has been agreed, this letter will remain effective, from one audit appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the (consolidated)* financial statements including our respective responsibilities.

(8.2 Since the terms of our engagement as auditors of the subsidiaries listed in the attached appendix are the same, we will not send separate letters to the board of directors of each subsidiary. We would therefore be grateful if you would forward copies of this letter to the boards of directors of each such subsidiary and confirm that these boards have also agreed and confirmed their acceptance of this letter.)*

Yours faithfully,

ABC & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

Date

We agree to the terms of this letter.

(Signed)

....
Director, for and on behalf of the board of

Date

---

* Delete where not applicable.

Note

When accounting, taxation or other services are undertaken on behalf of an audit client, information may be provided to members of the audit firm other than those engaged on the audit. In such cases, it may be appropriate for the audit engagement letter to include this or a similar paragraph to indicate that the auditor is not to be treated as having notice, for the purposes of the auditor's responsibilities, of such information, to make it clear that a company would not be absolved from informing the auditor directly of a material matter.

applicable where the company prepares an annual report which contain other information in addition to the directors' report.

Appendix 2

(Ref: Para. A10)

Determining the Acceptability of General Purpose Frameworks

Jurisdictions that Do Not Have Authorized or Recognized Standards Setting Organizations or Financial Reporting Frameworks Prescribed by Law or Regulation

1. As explained in paragraph A10 of this HKSA, when an entity is registered or operating in a jurisdiction that does not have an authorized or recognized standards setting organization, or where use of the financial reporting framework is not prescribed by law or regulation, management identifies an applicable financial reporting framework. Practice in such jurisdictions is often to use the financial reporting standards established by one of the organizations described in paragraph A8 of this HKSA.

2. Alternatively, there may be established accounting conventions in a particular jurisdiction that are generally recognized as the financial reporting framework for general purpose financial statements prepared by certain specified entities operating in that jurisdiction. When such a financial reporting framework is adopted, the auditor is required by paragraph 6(a) of this HKSA to determine whether the accounting conventions collectively can be considered to constitute an acceptable financial reporting framework for general purpose financial statements. When the accounting conventions are widely used in a particular jurisdiction, the accounting profession in that jurisdiction may have considered the acceptability of the financial reporting framework on behalf of the auditors. Alternatively, the auditor may make this determination by considering whether the accounting conventions exhibit attributes normally exhibited by acceptable financial reporting frameworks (see paragraph 3 below), or by comparing the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable (see paragraph 4 below).

3. Acceptable financial reporting frameworks normally exhibit the following attributes that result in information provided in financial statements that is useful to the intended users:

   (a) Relevance, in that the information provided in the financial statements is relevant to the nature of the entity and the purpose of the financial statements. For example, in the case of a business enterprise that prepares general purpose financial statements, relevance is assessed in terms of the information necessary to meet the common financial information needs of a wide range of users in making economic decisions. These needs are ordinarily met by presenting the financial position, financial performance and cash flows of the business enterprise.

   (b) Completeness, in that transactions and events, account balances and disclosures that could affect conclusions based on the financial statements are not omitted.

   (c) Reliability, in that the information provided in the financial statements:

      (i) Where applicable, reflects the economic substance of events and transactions and not merely their legal form; and

      (ii) Results in reasonably consistent evaluation, measurement, presentation and disclosure, when used in similar circumstances.

   (d) Neutrality, in that it contributes to information in the financial statements that is free from bias.

(e) Understandability, in that the information in the financial statements is clear and comprehensive and not subject to significantly different interpretation.

4. The auditor may decide to compare the accounting conventions to the requirements of an existing financial reporting framework considered to be acceptable. For example, the auditor may compare the accounting conventions to HKFRSs. For an audit of a small entity, the auditor may decide to compare the accounting conventions to a financial reporting framework specifically developed for such entities by an authorized or recognized standards setting organization. When the auditor makes such a comparison and differences are identified, the decision as to whether the accounting conventions adopted in the preparation of the financial statements constitute an acceptable financial reporting framework includes considering the reasons for the differences and whether application of the accounting conventions, or the description of the financial reporting framework in the financial statements, could result in financial statements that are misleading.

5. A conglomeration of accounting conventions devised to suit individual preferences is not an acceptable financial reporting framework for general purpose financial statements. Similarly, a compliance framework will not be an acceptable financial reporting framework, unless it is generally accepted in the particular jurisdictions by preparers and users.

HKSA 220

Issued June 2009; revised July 2010, May 2013, February 2015, August 2015, June 2017

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

Hong Kong Standard on Auditing 220

Quality Control for an Audit of Financial Statements

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

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HONG KONG STANDARD ON AUDITING 220
QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

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

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Hong Kong Standard on Auditing (HKSA) 220, *Quality Control for an Audit of Financial Statements*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

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

System of Quality Control and Role of Engagement Teams

2. Quality control systems, policies and procedures are the responsibility of the audit firm. Under HKSQC 1, the firm has an obligation to establish and maintain a system of quality control to provide it with reasonable assurance that:

   (a) The firm and its personnel comply with professional standards and applicable legal and regulatory requirements; and

   (b) Reports issued by the firm or engagement partners are appropriate in the circumstances.[1]

   This HKSA is premised on the basis that the firm is subject to HKSQC 1. (Ref: Para. A1)

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

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

Effective Date

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

Objective

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

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

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

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

Definitions

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

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

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

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

   (d) Engagement team – All partners and staff performing the engagement, and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor's external expert engaged by the firm or a network firm.[3] The term "engagement team" also excludes individuals within the client's internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of HKSA 610 (Revised 2013).[4]

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

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

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

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

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

   (j) Network – A larger structure:

      (i) That is aimed at cooperation, and

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

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

[4] HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*, establishes limits on the use of direct assistance. It also acknowledges that the external auditor may be prohibited by law or regulation from obtaining direct assistance from internal auditors. Therefore, the use of direct assistance is restricted to situations where it is permitted.

(ii) That is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality control policies and procedures, common business strategy, the use of a common brand name, or a significant part of professional resources.

(k) Partner – Any individual with authority to bind the firm with respect to the performance of a professional services engagement.

(l) Personnel – Partners and staff.

(m) Professional standards – HKICPA engagement standards, as defined in the HKICPA's *Preface to the Hong Kong Standards on Quality Control, Auditing, Review, Other Assurance and Related Services*, and relevant ethical requirements.

(n) Relevant ethical requirements – Ethical requirements to which the engagement team and engagement quality control reviewer are subject, which ordinarily comprise Parts A, B and D of the HKICPA's *Code of Ethics for Professional Accountants* (the Code) related to an audit of financial statements.

(o) Staff – Professionals, other than partners, including any experts the firm employs.

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

Requirements

Leadership Responsibilities for Quality on Audits

8. The engagement partner shall take responsibility for the overall quality on each audit engagement to which that partner is assigned. (Ref: Para. A3)

Relevant Ethical Requirements

9. Throughout the audit engagement, the engagement partner shall remain alert, through observation and making inquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team. (Ref: Para. A4-A5)

10. If matters come to the engagement partner's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm, shall determine the appropriate action. (Ref: Para. A5)

Independence

11. The engagement partner shall form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner shall: (Ref: Para. A5)

    (a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(b) Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is possible under applicable law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (Ref: Para. A6-A7)

Acceptance and Continuance of Client Relationships and Audit Engagements

12. The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

13. If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)

Assignment of Engagement Teams

14. The engagement partner shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to:

    (a) Perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and

    (b) Enable an auditor's report that is appropriate in the circumstances to be issued. (Ref: Para. A10-A12)

Engagement Performance

Direction, Supervision and Performance

15. The engagement partner shall take responsibility for:

    (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and (Ref: Para. A13-A15, A20)

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

Reviews

16. The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)

17. On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)

Consultation

18. The engagement partner shall:

    (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;

    (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;

    (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and

    (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)

Engagement Quality Control Review

19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:

    (a) Determine that an engagement quality control reviewer has been appointed;

    (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and

    (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)

20. The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve:

    (a) Discussion of significant matters with the engagement partner;

    (b) Review of the financial statements and the proposed auditor's report;

    (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and

    (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-A28, A30-A32)

21. For audits of financial statements of listed entities, the engagement quality control reviewer, on performing an engagement quality control review, shall also consider the following:

    (a) The engagement team's evaluation of the firm's independence in relation to the audit engagement;

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

(c) Whether audit documentation selected for review reflects the work performed in relation to the significant judgments and supports the conclusions reached. (Ref: Para. A29-A32)

Differences of Opinion

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

Monitoring

23. An effective system of quality control includes a monitoring process designed to provide the firm with reasonable assurance that its policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. The engagement partner shall consider the results of the firm's monitoring process as evidenced in the latest information circulated by the firm and, if applicable, other network firms and whether deficiencies noted in that information may affect the audit engagement. (Ref: Para A33-A35)

Documentation

24. The auditor shall include in the audit documentation: [5]

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

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

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

(d) The nature and scope of, and conclusions resulting from, consultations undertaken during the course of the audit engagement. (Ref: Para. A36)

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

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

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

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

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[5] HKSA 230, *Audit Documentation*, paragraphs 8-11, and A6

Conformity and Compliance with International Standards on Auditing

26. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 220, *Quality Control for an Audit of Financial Statements*. Compliance with the requirements of this HKSA ensures compliance with ISA 220.

***

Application and Other Explanatory Material

System of Quality Control and Role of Engagement Teams (Ref: Para. 2)

A1. HKSQC 1 deals with the firm's responsibilities to establish and maintain its system of quality control for audit engagements. The system of quality control includes policies and procedures that address each of the following elements:

- Leadership responsibilities for quality within the firm;
- Relevant ethical requirements;
- Acceptance and continuance of client relationships and specific engagements;
- Human resources;
- Engagement performance; and
- Monitoring.

HKSQC 1 contains requirements which are at least as demanding as its international equivalent, ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*[*], as it addresses all the elements referred to in ISQC 1 and imposes obligations on the firm that achieve the aims of the requirements set out in ISQC 1.

Reliance on the Firm's System of Quality Control (Ref: Para. 4)

A2. Unless information provided by the firm or other parties suggest otherwise, the engagement team may rely on the firm's system of quality control in relation to, for example:

- Competence of personnel through their recruitment and formal training.
- Independence through the accumulation and communication of relevant independence information.
- Maintenance of client relationships through acceptance and continuance systems.
- Adherence to applicable legal and regulatory requirements through the monitoring process.

[*] Issued by the International Auditing and Assurance Standards Board.

Leadership Responsibilities for Quality on Audits (Ref: Para. 8)

A3. The actions of the engagement partner and appropriate messages to the other members of the engagement team, in taking responsibility for the overall quality on each audit engagement, emphasize:

(a) The importance to audit quality of:

(i) Performing work that complies with professional standards and applicable legal and regulatory requirements;

(ii) Complying with the firm's quality control policies and procedures as applicable;

(iii) Issuing auditor's reports that are appropriate in the circumstances; and

(iv) The engagement team's ability to raise concerns without fear of reprisals; and

(b) The fact that quality is essential in performing audit engagements.

Relevant Ethical Requirements

Compliance with Relevant Ethical Requirements (Ref: Para. 9)

A4. The Code establishes the fundamental principles of professional ethics, which include:

(a) Integrity;

(b) Objectivity;

(c) Professional competence and due care;

(d) Confidentiality; and

(e) Professional behavior.

Definition of "Firm," "Network" and "Network Firm" (Ref: Para. 9-11)

A5. The definitions of "firm," "network" or "network firm" in relevant ethical requirements may differ from those set out in this HKSA. For example, the Code defines the "firm" as:

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

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

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

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

In complying with the requirements in paragraphs 9-11, the definitions used in the relevant ethical requirements apply in so far as is necessary to interpret those ethical requirements.

Threats to Independence (Ref: Para. 11(c))

A6. The engagement partner may identify a threat to independence regarding the audit engagement that safeguards may not be able to eliminate or reduce to an acceptable level. In that case, as required by paragraph 11(c), the engagement partner reports to the relevant person(s) within the firm to determine appropriate action, which may include eliminating the activity or interest that creates the threat, or withdrawing from the audit engagement, where withdrawal is possible under applicable law or regulation.

Considerations Specific to Public Sector Entities

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

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

A8. HKSQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.[6] Information such as the following assists the engagement partner in determining whether the conclusions reached regarding the acceptance and continuance of client relationships and audit engagements are appropriate:

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

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

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

Assignment of Engagement Teams (Ref: Para. 14)

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

[6] HKSQC 1, paragraph 27(a)

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

- Understanding of, and practical experience with, audit engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and applicable legal and regulatory requirements.
- Technical expertise, including expertise with relevant information technology and specialized areas of accounting or auditing.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

Considerations Specific to Public Sector Entities

A12. In the public sector, additional appropriate competence may include skills that are necessary to discharge the terms of the audit mandate in a particular jurisdiction. Such competence may include an understanding of the applicable reporting arrangements, including reporting to the legislature or other governing body or in the public interest. The wider scope of a public sector audit may include, for example, some aspects of performance auditing or a comprehensive assessment of compliance with law, regulation or other authority and preventing and detecting fraud and corruption.

Engagement Performance

Direction, Supervision and Performance (Ref: Para. 15(a))

A13. Direction of the engagement team involves informing the members of the engagement team of matters such as:

- Their responsibilities, including the need to comply with relevant ethical requirements, and to plan and perform an audit with professional skepticism as required by HKSA 200.[7]
- Responsibilities of respective partners where more than one partner is involved in the conduct of an audit engagement.
- The objectives of the work to be performed.
- The nature of the entity's business.
- Risk-related issues.
- Problems that may arise.
- The detailed approach to the performance of the engagement.

[7] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 15

Discussion among members of the engagement team allows less experienced team members to raise questions with more experienced team members so that appropriate communication can occur within the engagement team.

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

A15. Supervision includes matters such as:

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

Reviews

Review Responsibilities (Ref: Para. 16)

A16. Under HKSQC 1, the firm's review responsibility policies and procedures are determined on the basis that work of less experienced team members is reviewed by more experienced team members.[8]

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

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

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

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

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[8] HKSQC 1, paragraph 33

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

- Significant risks; and

- Other areas the engagement partner considers important.

The engagement partner need not review all audit documentation, but may do so. However, as required by HKSA 230, the partner documents the extent and timing of the reviews.[9]

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

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

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

- Agreeing with that member the nature, scope and objectives of that member's work; and the respective roles of, and the nature, timing and extent of communication between that member and other members of the engagement team.

- Evaluating the adequacy of that member's work including the relevance and reasonableness of that member's findings or conclusions and their consistency with other audit evidence.

Consultation (Ref: Para. 18)

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

- Are given all the relevant facts that will enable them to provide informed advice; and

- Have appropriate knowledge, seniority and experience.

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

Engagement Quality Control Review

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

A23. HKSA 700 (Revised) requires the auditor's report to be dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence on which to base the auditor's opinion on the financial statements.[10] In cases of an audit of financial statements of listed entities or when an engagement meets the criteria for an engagement quality control review, such a review assists the auditor in determining whether sufficient appropriate evidence has been obtained.

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[9] HKSA 230, paragraph 9(c)

[10] HKSA 700 (Revised) , *Forming an Opinion and Reporting on Financial Statements*, paragraph 49

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

A25. Completion of the engagement quality control review means the completion by the engagement quality control reviewer of the requirements in paragraphs 20-21, and where applicable, compliance with paragraph 22. Documentation of the engagement quality control review may be completed after the date of the auditor's report as part of the assembly of the final audit file. HKSA 230 establishes requirements and provides guidance in this regard.[11]

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

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

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

A28. When HKSA 701[12] applies, the conclusions reached by the engagement team in formulating the auditor's report include determining:

- The key audit matters to be included in the auditor's report;
- The key audit matters that will not be communicated in the auditor's report in accordance with paragraph 14 of HKSA 701, if any; and
- If applicable, depending on the facts and circumstances of the entity and the audit, that there are no key audit matters to communicate in the auditor's report.

In addition, the review of the proposed auditor's report in accordance with paragraph 20(b) includes consideration of the proposed wording to be included in the Key Audit Matters section.

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

A29. Other matters relevant to evaluating the significant judgments made by the engagement team that may be considered in an engagement quality control review of a listed entity include:

- Significant risks identified during the engagement in accordance with HKSA 315 (Revised),[13] and the responses to those risks in accordance with HKSA 330,[14] including the engagement team's assessment of, and response to, the risk of fraud in accordance with HKSA 240.[15]
- Judgments made, particularly with respect to materiality and significant risks.

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11 HKSA 230, paragraphs 14-16

12 HKSA 701, *Communicating Key Audit Matters in the Auditor's Report*

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

14 HKSA 330, *The Auditor's Responses to Assessed Risks*

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

- The significance and disposition of corrected and uncorrected misstatements identified during the audit.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

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

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

A30. In addition to the audits of financial statements of listed entities, an engagement quality control review is required for audit engagements that meet the criteria established by the firm that subjects engagements to an engagement quality control review. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review.

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

A31. In the public sector, a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General), may act in a role equivalent to that of engagement partner with overall responsibility for public sector audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.

A32. Listed entities as referred to in paragraphs 21 and A29 are not common in the public sector. However, there may be other public sector entities that are significant due to size, complexity or public interest aspects, and which consequently have a wide range of stakeholders. Examples include state owned corporations and public utilities. Ongoing transformations within the public sector may also give rise to new types of significant entities. There are no fixed objective criteria on which the determination of significance is based. Nonetheless, public sector auditors evaluate which entities may be of sufficient significance to warrant performance of an engagement quality control review.

Monitoring (Ref: Para. 23)

A33. HKSQC 1 requires the firm to establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate and operating effectively.[16]

A34. In considering deficiencies that may affect the audit engagement, the engagement partner may have regard to measures the firm took to rectify the situation that the engagement partner considers are sufficient in the context of that audit.

A35. A deficiency in the firm's system of quality control does not necessarily indicate that a particular audit engagement was not performed in accordance with professional standards and applicable legal and regulatory requirements, or that the auditor's report was not appropriate.

[16] HKSQC 1, paragraph 48

Documentation

Documentation of Consultations (Ref: Para. 24(d))

A36. Documentation of consultations with other professionals that involve difficult or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

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

HKSA 230

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

Hong Kong Standard on Auditing 230

Audit Documentation

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Certified Public Accountants
香港會計師公會

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HONG KONG STANDARD ON AUDITING 230

AUDIT DOCUMENTATION

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

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Hong Kong Standard on Auditing (HKSA) 230, *Audit Documentation*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements. The Appendix lists other HKSAs that contain specific documentation requirements and guidance. The specific documentation requirements of other HKSAs do not limit the application of this HKSA. Law or regulation may establish additional documentation requirements.

Nature and Purposes of Audit Documentation

2. Audit documentation that meets the requirements of this HKSA and the specific documentation requirements of other relevant HKSAs provides:

   (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; [1] and

   (b) Evidence that the audit was planned and performed in accordance with HKSAs and applicable legal and regulatory requirements.

3. Audit documentation serves a number of additional purposes, including the following:

   - Assisting the engagement team to plan and perform the audit.
   - Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with HKSA 220.[2]
   - Enabling the engagement team to be accountable for its work.
   - Retaining a record of matters of continuing significance to future audits.
   - Enabling the conduct of quality control reviews and inspections in accordance with HKSQC 1[3].[4]
   - Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Effective Date

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

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[1] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 11

[2] HKSA 220, *Quality Control for an Audit of Financial Statements*, paragraphs 15-17

[3] HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraphs 32-33, 35-38, and 48

[4] HKSA 220, paragraph 2

Objective

5. The objective of the auditor is to prepare documentation that provides:

   (a) A sufficient and appropriate record of the basis for the auditor's report; and

   (b) Evidence that the audit was planned and performed in accordance with HKSAs and applicable legal and regulatory requirements.

Definitions

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

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

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

   (c) Experienced auditor – An individual (whether internal or external to the firm) who has practical audit experience, and a reasonable understanding of:

      (i) Audit processes;

      (ii) HKSAs and applicable legal and regulatory requirements;

      (iii) The business environment in which the entity operates; and

      (iv) Auditing and financial reporting issues relevant to the entity's industry.

Requirements

Timely Preparation of Audit Documentation

7. The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16-A17)

   (a) The nature, timing, and extent of the audit procedures performed to comply with the HKSAs and applicable legal and regulatory requirements; (Ref: Para. A6-A7)

   (b) The results of the audit procedures performed, and the audit evidence obtained; and

   (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8-A11)

9. In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

   (a) The identifying characteristics of the specific items or matters tested; (Ref: Para. A12)

   (b) Who performed the audit work and the date such work was completed; and

   (c) Who reviewed the audit work performed and the date and extent of such review. (Ref: Para. A13)

10. The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place. (Ref: Para. A14)

11. If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency. (Ref: Para. A15)

Departure from a Relevant Requirement

12. If, in exceptional circumstances, the auditor judges it necessary to depart from a relevant requirement in an HKSA, the auditor shall document how the alternative audit procedures performed achieve the aim of that requirement, and the reasons for the departure. (Ref: Para. A18-A19)

Matters Arising after the Date of the Auditor's Report

13. If, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document: (Ref: Para. A20)

   (a) The circumstances encountered;

   (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and

   (c) When and by whom the resulting changes to audit documentation were made and reviewed.

Assembly of the Final Audit File

14. The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report. (Ref: Para. A21-A22)

15. After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period. (Ref: Para. A23)

16. In circumstances other than those envisaged in paragraph 13 where the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor shall, regardless of the nature of the modifications or additions, document: (Ref: Para. A24)

   (a) The specific reasons for making them; and

   (b) When and by whom they were made and reviewed.

Conformity and Compliance with International Standards on Auditing

17. As of June 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 230, *Audit Documentation*. Compliance with the requirements of this HKSA ensures compliance with ISA 230.

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Application and Other Explanatory Material

Timely Preparation of Audit Documentation (Ref: Para. 7)

A1. Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation (Ref: Para. 8)

A2. The form, content and extent of audit documentation depend on factors such as:

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The audit methodology and tools used.

A3. Audit documentation may be recorded on paper or on electronic or other media. Examples of audit documentation include:

- Audit programs.
- Analyses.
- Issues memoranda.
- Summaries of significant matters.
- Letters of confirmation and representation.
- Checklists.
- Correspondence (including e-mail) concerning significant matters.

The auditor may include abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) as part of audit documentation. Audit documentation, however, is not a substitute for the entity's accounting records.

A4. The auditor need not include in audit documentation superseded drafts of working papers and financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

A5. Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached, but may be used to explain or clarify information contained in the audit documentation.

Documentation of Compliance with HKSAs (Ref: Para. 8(a))

A6. In principle, compliance with the requirements of this HKSA will result in the audit documentation being sufficient and appropriate in the circumstances. Other HKSAs contain specific documentation requirements that are intended to clarify the application of this HKSA in the particular circumstances of those other HKSAs. The specific documentation requirements of other HKSAs do not limit the application of this HKSA. Furthermore, the absence of a documentation requirement in any particular HKSA is not intended to suggest that there is no documentation that will be prepared as a result of complying with that HKSA.

A7. Audit documentation provides evidence that the audit complies with the HKSAs. However, it is neither necessary nor practicable for the auditor to document every matter considered, or professional judgment made, in an audit. Further, it is unnecessary for the auditor to document separately (as in a checklist, for example) compliance with matters for which compliance is demonstrated by documents included within the audit file. For example:

- The existence of an adequately documented audit plan demonstrates that the auditor has planned the audit.
- The existence of a signed engagement letter in the audit file demonstrates that the auditor has agreed the terms of the audit engagement with management or, where appropriate, those charged with governance.
- An auditor's report containing an appropriately qualified opinion on the financial statements demonstrates that the auditor has complied with the requirement to express a qualified opinion under the circumstances specified in the HKSAs.
- In relation to requirements that apply generally throughout the audit, there may be a number of ways in which compliance with them may be demonstrated within the audit file:
    - For example, there may be no single way in which the auditor's professional skepticism is documented. But the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism in accordance with the HKSAs. Such evidence may include specific procedures performed to corroborate management's responses to the auditor's inquiries.

    ○ Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the HKSAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussions required by HKSA 315 (Revised).[5]

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:

- Matters that give rise to significant risks (as defined in HKSA 315 (Revised)). [6]
- Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

A9. An important factor in determining the form, content and extent of audit documentation of significant matters is the extent of professional judgment exercised in performing the work and evaluating the results. Documentation of the professional judgments made, where significant, serves to explain the auditor's conclusions and to reinforce the quality of the judgment. Such matters are of particular interest to those responsible for reviewing audit documentation, including those carrying out subsequent audits when reviewing matters of continuing significance (for example, when performing a retrospective review of accounting estimates).

A10. Some examples of circumstances in which, in accordance with paragraph 8, it is appropriate to prepare audit documentation relating to the use of professional judgment include, where the matters and judgments are significant:

- The rationale for the auditor's conclusion when a requirement provides that the auditor "shall consider" certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments (for example, the reasonableness of significant accounting estimates).
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
- When HKSA 701 applies,[7] the auditor's determination of the key audit matters or the determination that there are no key audit matters to be communicated.

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5 HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 10

6 HKSA 315 (Revised), paragraph 4(e)

7 HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

A11. The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes the significant matters identified during the audit and how they were addressed, or that includes cross-references to other relevant supporting audit documentation that provides such information. Such a summary may facilitate effective and efficient reviews and inspections of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist the auditor's consideration of the significant matters. It may also help the auditor to consider whether, in light of the audit procedures performed and conclusions reached, there is any individual relevant HKSA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Identification of Specific Items or Matters Tested, and of the Preparer and Reviewer (Ref: Para. 9)

A12. Recording the identifying characteristics serves a number of purposes. For example, it enables the engagement team to be accountable for its work and facilitates the investigation of exceptions or inconsistencies. Identifying characteristics will vary with the nature of the audit procedure and the item or matter tested. For example:

- For a detailed test of entity-generated purchase orders, the auditor may identify the documents selected for testing by their dates and unique purchase order numbers.
- For a procedure requiring selection or review of all items over a specific amount from a given population, the auditor may record the scope of the procedure and identify the population (for example, all journal entries over a specified amount from the journal register).
- For a procedure requiring systematic sampling from a population of documents, the auditor may identify the documents selected by recording their source, the starting point and the sampling interval (for example, a systematic sample of shipping reports selected from the shipping log for the period from 1 April to 30 September, starting with report number 12345 and selecting every 125^{th} report).
- For a procedure requiring inquiries of specific entity personnel, the auditor may record the dates of the inquiries and the names and job designations of the entity personnel.
- For an observation procedure, the auditor may record the process or matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out.

A13. HKSA 220 requires the auditor to review the audit work performed through review of the audit documentation.[8] The requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The requirement, however, means documenting what audit work was reviewed, who reviewed such work, and when it was reviewed.

Documentation of Discussions of Significant Matters with Management, Those Charged with Governance, and Others (Ref: Para. 10)

A14. The documentation is not limited to records prepared by the auditor but may include other appropriate records such as minutes of meetings prepared by the entity's personnel and agreed by the auditor. Others with whom the auditor may discuss significant matters may include other personnel within the entity, and external parties, such as persons providing professional advice to the entity.

[8] HKSA 220, paragraph 17

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

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

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

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

A17. When preparing audit documentation, the auditor of a smaller entity may also find it helpful and efficient to record various aspects of the audit together in a single document, with cross-references to supporting working papers as appropriate. Examples of matters that may be documented together in the audit of a smaller entity include the understanding of the entity and its internal control, the overall audit strategy and audit plan, materiality determined in accordance with HKSA 320,[9] assessed risks, significant matters noted during the audit, and conclusions reached.

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

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

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

(a) The entire HKSA is not relevant (for example, if an entity does not have an internal audit function , nothing in HKSA 610 (Revised 2013)[11] is relevant); or

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

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

A20. Examples of exceptional circumstances include facts which become known to the auditor after the date of the auditor's report but which existed at that date and which, if known at that date, might have caused the financial statements to be amended or the auditor to modify the opinion in the auditor's report.[12] The resulting changes to the audit documentation are reviewed in accordance with the review responsibilities set out in HKSA 220,[13] with the engagement partner taking final responsibility for the changes.

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[9] HKSA 320, *Materiality in Planning and Performing an Audit*

[10] HKSA 200, paragraph 22

[11] HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 2

[12] HKSA 560, *Subsequent Events*, paragraph 14

[13] HKSA 220, paragraph 16

Assembly of the Final Audit File (Ref: Para. 14-16)

A21. HKSQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files.[14] An appropriate time limit within which to complete the assembly of the final audit file is ordinarily not more than 60 days after the date of the auditor's report.[15]

A22. The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. Changes may, however, be made to the audit documentation during the final assembly process if they are administrative in nature. Examples of such changes include:

- Deleting or discarding superseded documentation.
- Sorting, collating and cross-referencing working papers.
- Signing off on completion checklists relating to the file assembly process.
- Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

A23. HKSQC 1 requires firms to establish policies and procedures for the retention of engagement documentation.[16] The retention period for audit engagements ordinarily is no shorter than five years from the date of the auditor's report, or, if later, the date of the group auditor's report.[17]

A24. An example of a circumstance in which the auditor may find it necessary to modify existing audit documentation or add new audit documentation after file assembly has been completed is the need to clarify existing audit documentation arising from comments received during monitoring inspections performed by internal or external parties.

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[14] HKSQC 1, paragraph 45

[15] HKSQC 1, paragraph A54

[16] HKSQC 1, paragraph 47

[17] HKSQC 1, paragraph A61

Appendix

(Ref: Para. 1)

Specific Audit Documentation Requirements in Other HKSAs

This appendix identifies paragraphs in other HKSAs that contain specific documentation requirements. The list is not a substitute for considering the requirements and related application and other explanatory material in HKSAs.

- HKSA 210, *Agreeing the Terms of Audit Engagements* – paragraphs 10-12
- HKSA 220, *Quality Control for an Audit of Financial Statements* – paragraphs 24-25
- HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 44-47
- HKSA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 29; HKAS 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 30
- HKSA 260 (Revised), *Communication with Those Charged with Governance* – paragraph 23
- HKSA 300, *Planning an Audit of Financial Statements* – paragraph 12
- HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* – paragraph 32
- HKSA 320, *Materiality in Planning and Performing an Audit* – paragraph 14
- HKSA 330, *The Auditor's Responses to Assessed Risks* – paragraphs 28-30
- HKSA 450, *Evaluation of Misstatements Identified during the Audit* – paragraph 15
- HKSA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* – paragraph 23
- HKSA 550, *Related Parties* – paragraph 28
- HKSA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* – paragraph 50
- HKSA 610 (Revised 2013), *Using the Work of Internal Auditors* – paragraphs 36-37
- HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* – paragraph 25

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Hong Kong Standard on Auditing 240

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

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

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Appendix 4: Additional local guidance on Reporting Fraud to an Appropriate Authority Outside the Entity

Hong Kong Standard on Auditing (HKSA) 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

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

Characteristics of Fraud

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

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

Responsibility for the Prevention and Detection of Fraud

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

Responsibilities of the Auditor

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

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

[2] HKSA 330, *The Auditor’s Responses to Assessed Risks*

[3] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraphs A53-A54

6. As described in HKSA 200,[4] the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

7. Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

8. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this HKSA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Effective Date

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

Objectives

10. The objectives of the auditor are:

    (a) To identify and assess the risks of material misstatement of the financial statements due to fraud;

    (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and

    (c) To respond appropriately to fraud or suspected fraud identified during the audit.

Definitions

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

    (a) Fraud – An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

[4] HKSA 200, paragraph A53

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

Requirements

Professional Skepticism

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

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

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

Discussion among the Engagement Team

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

Risk Assessment Procedures and Related Activities

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

Management and Others within the Entity

17. The auditor shall make inquiries of management regarding:

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

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

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

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[5] HKSA 200, paragraph 15

[6] HKSA 315 (Revised), paragraph 10

[7] HKSA 315 (Revised), paragraphs 5-24

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

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

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

Those Charged with Governance

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

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

Unusual or Unexpected Relationships Identified

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

Other Information

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

Evaluation of Fraud Risk Factors

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

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

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

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8 HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

9 HKSA 315 (Revised), paragraph 25

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

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

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses

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

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

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

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

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

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

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

Audit Procedures Responsive to Risks Related to Management Override of Controls

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

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[10] HKSA 330, paragraph 5

[11] HKSA 330, paragraph 6

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

Communications to Management and with Those Charged with Governance

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

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

(a) management;

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

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

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

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

Communications to Regulatory and Enforcement Authorities[11a]

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

Documentation

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

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

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

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

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

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

[13] HKSA 315 (Revised), paragraph 32

[14] HKSA 330, paragraph 28

adjustment of assumptions and changes in judgments by management. Pressures and incentives may lead these actions to increase to the extent that they result in fraudulent financial reporting. Such a situation could occur when, due to pressures to meet market expectations or a desire to maximize compensation based on performance, management intentionally takes positions that lead to fraudulent financial reporting by materially misstating the financial statements. In some entities, management may be motivated to reduce earnings by a material amount to minimize tax or to inflate earnings to secure bank financing.

A3. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

A4. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as intentionally:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Omitting, obscuring or misstating disclosures required by the applicable financial reporting framework, or disclosures that are necessary to achieve fair presentation.
- Concealing facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

A5. Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways including:

- Embezzling receipts (for example, misappropriating collections on accounts receivable or diverting receipts in respect of written-off accounts to personal bank accounts).
- Stealing physical assets or intellectual property (for example, stealing inventory for personal use or for sale, stealing scrap for resale, colluding with a competitor by disclosing technological data in return for payment).
- Causing an entity to pay for goods and services not received (for example, payments to fictitious vendors, kickbacks paid by vendors to the entity's purchasing agents in return for inflating prices, payments to fictitious employees).
- Using an entity's assets for personal use (for example, using the entity's assets as

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

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

Considerations Specific to Public Sector Entities

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

Professional Skepticism (Ref: Para. 12-14)

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

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

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

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

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

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

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

[15] HKSA 200, paragraph A49

A11. The discussion may include such matters as:

- An exchange of ideas among engagement team members about how and where they believe the entity's financial statements (including the individual statements and the disclosures) may be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- A consideration of circumstances that might be indicative of earnings management and the practices that might be followed by management to manage earnings that could lead to fraudulent financial reporting.
- A consideration of the risk that management may attempt to present disclosures in a manner that may obscure a proper understanding of the matters disclosed (for example, by including too much immaterial information or by using unclear or ambiguous language).
- A consideration of the known external and internal factors affecting the entity that may create an incentive or pressure for management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of management's involvement in overseeing employees with access to cash or other assets susceptible to misappropriation.
- A consideration of any unusual or unexplained changes in behavior or lifestyle of management or employees which have come to the attention of the engagement team.
- An emphasis on the importance of maintaining a proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- A consideration of the audit procedures that might be selected to respond to the susceptibility of the entity's financial statement to material misstatement due to fraud and whether certain types of audit procedures are more effective than others.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of the risk of management override of controls.

Risk Assessment Procedures and Related Activities

Inquiries of Management

Management's Assessment of the Risk of Material Misstatement Due to Fraud (Ref: Para. 17(a))

A12. Management accepts responsibility for the entity's internal control and for the preparation of the entity's financial statements. Accordingly, it is appropriate for the auditor to make inquiries of management regarding management's own assessment of the risk of fraud and the controls in place to prevent and detect it. The nature, extent and frequency of management's assessment of such risk and controls may vary from entity to entity. In some entities, management may make detailed assessments on an annual basis or as part of continuous monitoring. In other entities, management's assessment may be less structured and less frequent. The nature, extent and frequency of management's assessment are relevant to the auditor's understanding of the entity's control environment. For example, the fact that management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that management places on internal control.

Considerations specific to smaller entities

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

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

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

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

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

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

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

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

Inquiries of Internal Audit (Ref: Para. 19)

A18. HKSA 315 (Revised) and HKSA 610 (Revised 2013) establish requirements and provide guidance relevant to audits of those entities that have an internal audit function.[16] In carrying out the requirements of those HKSAs in the context of fraud, the auditor may inquire about specific activities of the function including, for example:

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

[16] HKSA 315 (Revised), paragraphs 6(a) and 23, and HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*

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

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

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

Considerations Specific to Smaller Entities

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

Consideration of Other Information (Ref: Para. 23)

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

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

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

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

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

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

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

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

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

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

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

Responses to the Assessed Risks of Material Misstatement Due to Fraud

Overall Responses (Ref: Para. 28)

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

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

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

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

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

[18] HKSA 315 (Revised), paragraph A56

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

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

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

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

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

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

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

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

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

[20] HKSA 330, paragraph 25

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

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

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

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

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

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

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

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

- The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances, even where the fraud is not material to the financial statements;
- The auditor's consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
- The auditor has significant concern about the competence or integrity of management or those charged with governance.

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

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

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

[22] HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

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

Considerations Specific to Public Sector Entities

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

Written Representations (Ref: Para. 39)

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

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

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

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

Communications to Management and with Those Charged with Governance

Communication to Management (Ref: Para. 40)

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

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

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

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

[24] HKSA 580, *Written Representations*

[25] HKSA 260 (Revised), paragraph A38

Appendix 4

(Ref: Para. 43)

Additional local guidance on Reporting Fraud to an Appropriate Authority Outside the Entity

1. This appendix provide guidance to an auditor on the circumstances in which to report to third parties who have a proper interest in receiving such information. In addition, an auditor of entities in regulated industries, who is required to report certain information direct to the relevant regulators, has separate responsibilities. Guidance on the auditor's responsibility to report direct to regulators in regulated industries is provided in Practice Note 820 (Revised), *The Audit of Licensed Corporations and Associated Entities of Intermediaries*, Practice Note 620.2 *Communication between the Auditor and the Insurance Authority*, Practice Note 860.1 (Revised), *The Audit of Retirement Schemes* and Practice Note 830 (Revised), *Reports by the Auditor under the Banking Ordinance*.

2. Where the auditor becomes aware of a suspected or actual instance of fraud which could have a material effect on the financial statements, he would:

   (a) consider whether the matter may be one that ought to be reported to a proper authority in the public interest; and where this is the case

   (b) except when he is prohibited by law from informing any party other than the proper authority or when the matter casts doubt on the integrity of those charged with governance, discuss the matter with those charged with governance, including any audit committee.

3. Where having discussed an identified suspected or actual instance of fraud which could have a material effect on the financial statements with those charged with governance and considered any views expressed on behalf of the entity and in the light of any legal advice obtained, the auditor concludes that the matter ought to be reported to a proper authority in the public interest, he would, except in the circumstances covered in paragraph 5(b) below, notify those charged with governance in writing of his view. If the entity does not voluntarily report the matter to a proper authority itself or is unable to provide evidence that the matter has been reported, the auditor would consider reporting it himself.

4. Confidentiality is an implied term of the auditor's contract. The duty of confidentiality, however, is not absolute. In certain exceptional circumstances an auditor is not bound by the duty of confidentiality and may report a suspected or actual instance of fraud which could have a material effect on the financial statements to a proper authority in the public interest. An auditor needs to weigh the public interest in maintaining confidential client relationships against the public interest in disclosure to a proper authority. Determination of where the balance of public interest lies requires careful consideration. An auditor whose suspicions has been aroused needs to use his professional judgment to determine whether his misgivings justify him in carrying the matter further or are too insubstantial to deserve reporting.

5. In respect of an identified suspected or actual instance of fraud which could have a material effect on the financial statements, the auditor would make a report direct to a proper authority in the public interest without delay and without informing those charged with governance in advance in situations where:

   (a) the auditor concludes that the matter ought to be reported to a proper authority in the public interest; and

   (b) the auditor is prohibited by law from informing any party other than the proper authority or the matter casts doubt on the integrity of those charged with governance.

6. Examples of circumstances which may cause the auditor no longer to have confidence in the integrity of those charged with governance include situations:

   (a) where he suspects or has evidence of the involvement or intended involvement of those charged with governance in possible fraud which could have a material effect on the financial statements; or

   (b) where he suspects or has evidence that those charged with governance are aware of such fraud and, contrary to regulatory requirements or the public interest, have not reported it to a proper authority within a reasonable period.

7. "Public interest" is a concept that is not capable of general definition. Each situation must be considered individually. Matters to be taken into account when considering whether disclosure is justified in the public interest may include:

   (a) the extent to which the suspected or actual fraud is likely to affect members of the public;

   (b) whether those charged with governance have rectified the matter or are taking, or are likely to take, effective corrective action;

   (c) the extent to which non-disclosure is likely to enable the suspected or actual fraud to recur with impunity;

   (d) the gravity of the matter; and

   (e) the weight of evidence and the degree of the auditor's suspicion that there has been an instance of fraud.

8. When reporting to proper authorities in the public interest it is important that an auditor only reports to one which has a proper interest to receive the information. Which body or person is the proper authority in a particular instance depends on the nature of the suspected or actual fraud. Proper authorities could include the Independent Commission Against Corruption, the Police, the Customs and Excise Department, the Joint Financial Intelligence Unit, Hong Kong Exchanges and Clearing Limited, the Securities and Futures Commission, the Hong Kong Monetary Authority, the Insurance Authority or the Mandatory Provident Fund Schemes Authority. In cases of doubt as to the appropriate authority an auditor is advised to seek legal advice.

9. An auditor receives the same protection even if he only has a reasonable suspicion that fraud has occurred. An auditor who can demonstrate that he has acted reasonably and in good faith in informing an authority of an instance of fraud which he thinks has been committed would not be held by the court to be in breach of duty to the client even if, an investigation or prosecution having occurred, it were found that there has been no offence.

10. An auditor may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest.

11 An auditor needs to remember that his decision as to whether to report, and if so to whom, may be called into question at a future date, for example on the basis of

   (a) what he knew at the time;

   (b) what he ought to have known in the course of his audit;

   (c) what he ought to have concluded; and

   (d) what he ought to have done.

An auditor may also wish to consider the possible consequences if financial loss is occasioned as a result of fraud which he suspects (or ought to suspect) has occurred but decides not to report.

12. In addition to the duty of an auditor of entities in regulated industries to report direct to regulators in certain circumstances (see paragraph 1 above), an auditor and others have a statutory duty to take the initiative to disclose to an authorized officer (as defined in the Drug Trafficking (Recovery of Proceeds) Ordinance (DTROP), the Organized and Serious Crimes Ordinance (OSCO) and the United Nations (Anti-Terrorism Measures) Ordinance (UNATMO)) knowledge or suspicion that any property represents

    (a) proceeds of, or was used in connection with, or is intended to be used in connection with, drug trafficking under the DTROP;

    (b) proceeds of, or was used in connection with, or is intended to be used in connection with, an indictable offence under the OSCO ; and

    (c) terrorist property under the UNATMO.

    A failure to disclose in these circumstances is itself an offence. However, under the above legislation, a disclosure by an employee to an appropriate person designated for the purpose, according to the employer's procedures, is regarded as being the same as a disclosure to an authorized officer. It should also be noted that there are other offences under the respective Ordinances, including the offence of "tipping off", and further guidance on these offences and definitions of "authorized officer", "proceeds", etc. described above are provided in Anti-Money Laundering Bulletin (AMLB) 1 "Requirements on Anti-money Laundering, Anti-terrorist Financing and Related Matters" and a supplement to AMLB 1, "Frequently Asked Questions on Suspicious Transaction Reporting" issued by the Hong Kong Institute of Certified Public Accountants.

13. A disclosure made under DTROP or OSCO will not be treated as a breach of contract, any enactment, rule of conduct or other provision restricting disclosure of information and will not render the person making the disclosure liable in damages for any loss arising out of the disclosure.

14. A disclosure made under UNATMO will not be treated as a breach of any restriction upon the disclosure of information imposed by contract or by any enactment, rules of conduct or other provision. The person making the disclosure will not be liable in damages for any loss arising out of the disclosure, or any act done or omitted to be done in relation to the property concerned in consequence of the disclosure.

HKSA 250 (Revised)
Issued June 2017

Effective for audits of financial statements
for periods beginning on or after 15 December 2017

Hong Kong Standard on Auditing 250 (Revised)

Consideration of Laws and Regulations in an Audit of Financial Statements

Including Related Conforming Amendments to Other Hong Kong Standards

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

HONG KONG STANDARD ON AUDITING 250 (REVISED) CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods beginning on or after 15 December 2017)

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Hong Kong Standard on Auditing (HKSA) 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements,* should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

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

Effect of Laws and Regulations

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

Responsibility for Compliance with Laws and Regulations (Ref: Para. A1–A8)

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

Responsibility of the Auditor

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

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

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

[2] HKSA 200, paragraphs A53–A54

- There are many laws and regulations, relating principally to the operating aspects of an entity, that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
- Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor.
- Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognize the non-compliance.

6. This HKSA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows: (Ref: Para. A6, A12–A13)

   (a) The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations (see paragraph 14) (Ref: Para. A12); and

   (b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (e.g., compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); non-compliance with such laws and regulations may therefore have a material effect on the financial statements (see paragraph 15) (Ref: Para. A13).

7. In this HKSA, differing requirements are specified for each of the above categories of laws and regulations. For the category referred to in paragraph 6(a), the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations. For the category referred to in paragraph 6(b), the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

8. The auditor is required by this HKSA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of non-compliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by HKSA 200,[3] is important in this context, given the extent of laws and regulations that affect the entity.

9. The auditor may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, which may differ from or go beyond this HKSA, such as: (Ref: Para. A8)

   (a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and

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3 HKSA 200, paragraph 15

those charged with governance, assessing the appropriateness of their response to non-compliance and determining whether further action is needed;

(b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g., in an audit of group financial statements); and

(c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to the auditor's work in accordance with this and other HKSAs (e.g., regarding the integrity of management or, where appropriate, those charged with governance).

Effective Date

10. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2017.

Objectives

11. The objectives of the auditor are:

    (a) To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements;

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

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

Definition

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

    Non-compliance – Acts of omission or commission, intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. Non-compliance does not include personal misconduct unrelated to the business activities of the entity. (Ref: Para. A9–A10)

Requirements

The Auditor's Consideration of Compliance with Laws and Regulations

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

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

[4] HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 11

(b) How the entity is complying with that framework. (Ref: Para. A11)

14. The auditor shall obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements. (Ref: Para. A12)

15. The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements: (Ref: Para. A13–A14)

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

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

16. During the audit, the auditor shall remain alert to the possibility that other audit procedures applied may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. (Ref: Para. A15)

17. The auditor shall request management and, where appropriate, those charged with governance, to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor. (Ref: Para. A16)

18. In the absence of identified or suspected non-compliance, the auditor is not required to perform audit procedures regarding the entity's compliance with laws and regulations, other than those set out in paragraphs 13–17.

Audit Procedures When Non-Compliance Is Identified or Suspected

19. If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain: (Ref: Para. A17–A18)

(a) An understanding of the nature of the act and the circumstances in which it has occurred; and

(b) Further information to evaluate the possible effect on the financial statements. (Ref: Para. A19)

20. If the auditor suspects there may be non-compliance, the auditor shall discuss the matter, unless prohibited by law or regulation, with the appropriate level of management and, where appropriate, those charged with governance. If management or, as appropriate, those charged with governance do not provide sufficient information that supports that the entity is in compliance with laws and regulations and, in the auditor's judgment, the effect of the suspected non-compliance may be material to the financial statements, the auditor shall consider the need to obtain legal advice. (Ref: Para. A20–A22)

21. If sufficient information about suspected non-compliance cannot be obtained, the auditor shall evaluate the effect of the lack of sufficient appropriate audit evidence on the auditor's opinion.

22. The auditor shall evaluate the implications of identified or suspected non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations, and take appropriate action. (Ref: Para. A23–A25)

Communicating and Reporting Identified or Suspected Non-Compliance

Communicating Identified or Suspected Non-Compliance with Those Charged with Governance

23. Unless all of those charged with governance are involved in management of the entity, and therefore are aware of matters involving identified or suspected non-compliance already communicated by the auditor,[5] the auditor shall communicate, unless prohibited by law or regulation, with those charged with governance matters involving non-compliance with laws and regulations that come to the auditor's attention during the course of the audit, other than when the matters are clearly inconsequential.

24. If, in the auditor's judgment, the non-compliance referred to in paragraph 23 is believed to be intentional and material, the auditor shall communicate the matter with those charged with governance as soon as practicable.

25. If the auditor suspects that management or those charged with governance are involved in non-compliance, the auditor shall communicate the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or supervisory board. Where no higher authority exists, or if the auditor believes that the communication may not be acted upon or is unsure as to the person to whom to report, the auditor shall consider the need to obtain legal advice.

Potential Implications of Identified or Suspected Non-Compliance for the Auditor's Report (Ref: Para. A26–A27)

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

27. If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have, occurred, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements on the basis of a limitation on the scope of the audit in accordance with HKSA 705 (Revised).[7]

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

Reporting Identified or Suspected Non-Compliance to an Appropriate Authority outside the Entity

29. If the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether law, regulation or relevant ethical requirements: (Ref: Para. A28–A34)

    (a) Require the auditor to report to an appropriate authority outside the entity.

    (b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

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[5] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

[6] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraphs 7–8

[7] HKSA 705 (Revised), paragraphs 7 and 9

Documentation

30. The auditor shall include in the audit documentation[8] identified or suspected non-compliance with laws and regulations and: (Ref: Para. A35–A36)

    (a) The audit procedures performed, the significant professional judgments made and the conclusions reached thereon; and

    (b) The discussions of significant matters related to the non-compliance with management, those charged with governance and others, including how management and, where applicable, those charged with governance have responded to the matter.

Conformity and Compliance with International Standards on Auditing

31. As of June 2017 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. Compliance with the requirements of this HKSA ensures compliance with ISA 250. ISA 250 (Revised) has received the approval of the Public Interest Oversight Board (PIOB) which concluded that due process was followed in the development of the standard and that proper regard was paid to the public interest.

32. Additional local explanation is provided in footnotes 13a and 16a.

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Application and Other Explanatory Material

Responsibility for Compliance with Laws and Regulations (Ref: Para. 3–9)

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

A2. The following are examples of the types of policies and procedures an entity may implement to assist in the prevention and detection of non-compliance with laws and regulations:

- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate systems of internal control.
- Developing, publicizing and following a code of conduct.
- Ensuring employees are properly trained and understand the code of conduct.
- Monitoring compliance with the code of conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisors to assist in monitoring legal requirements.

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

- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to the following:

- An internal audit function.
- An audit committee.
- A compliance function.

Responsibility of the Auditor

A3. Non-compliance by the entity with laws and regulations may result in a material misstatement of the financial statements. Detection of non-compliance, regardless of materiality, may affect other aspects of the audit including, for example, the auditor's consideration of the integrity of management, those charged with governance or employees.

A4. Whether an act constitutes non-compliance with laws and regulations is a matter to be determined by a court or other appropriate adjudicative body, which is ordinarily beyond the auditor's professional competence to determine. Nevertheless, the auditor's training, experience and understanding of the entity and its industry or sector may provide a basis to recognize that some acts, coming to the auditor's attention, may constitute non-compliance with laws and regulations.

A5. In accordance with specific statutory requirements, the auditor may be specifically required to report, as part of the audit of the financial statements, on whether the entity complies with certain provisions of laws or regulations. In these circumstances, HKSA 700 (Revised)[9] or HKSA 800 (Revised)[10] deal with how these audit responsibilities are addressed in the auditor's report. Furthermore, where there are specific statutory reporting requirements, it may be necessary for the audit plan to include appropriate tests for compliance with these provisions of the laws and regulations.

Categories of Laws and Regulations (Ref: Para. 6)

A6. The nature and circumstances of the entity may impact whether relevant laws and regulations are within the categories of laws and regulations described in paragraphs 6(a) or 6(b). Examples of laws and regulations that may be included in the categories described in paragraph 6 include those that deal with:

- Fraud, corruption and bribery.
- Money laundering, terrorist financing and proceeds of crime.
- Securities markets and trading.
- Banking and other financial products and services.
- Data protection.
- Tax and pension liabilities and payments.

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[9] HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 43

[10] HKSA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, paragraph 11

- Environmental protection.
- Public health and safety.

Considerations Specific to Public Sector Entities

A7. In the public sector, there may be additional audit responsibilities with respect to the consideration of laws and regulations which may relate to the audit of financial statements or may extend to other aspects of the entity's operations.

Additional Responsibilities Established by Law, Regulation or Relevant Ethical Requirements (Ref: Para. 9)

A8. Law, regulation or relevant ethical requirements may require the auditor to perform additional procedures and take further actions. For example, the HKICPA's *Code of Ethics for Professional Accountants* (the Code) requires the auditor to take steps to respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed. Such steps may include the communication of identified or suspected non-compliance with laws and regulations to other auditors within a group, including a group engagement partner, component auditors or other auditors performing work at components of a group for purposes other than the audit of the group financial statements.[11]

Definition (Ref: Para. 12)

A9. Acts of non-compliance with laws and regulations include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, by management or by other individuals working for or under the direction of the entity.

A10. Non-compliance also includes personal misconduct related to the business activities of the entity, for example, in circumstances where an individual in a key management position, in a personal capacity, has accepted a bribe from a supplier of the entity and in return secures the appointment of the supplier to provide services or contracts to the entity.

The Auditor's Consideration of Compliance with Laws and Regulations

Obtaining an Understanding of the Legal and Regulatory Framework (Ref: Para. 13)

A11. To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example:

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements;
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

[11] See Sections 225.21–225.22 of the Code.

Laws and Regulations Generally Recognized to Have a Direct Effect on the Determination of Material Amounts and Disclosures in the Financial Statements (Ref: Para. 6, 14)

A12. Certain laws and regulations are well-established, known to the entity and within the entity's industry or sector, and relevant to the entity's financial statements (as described in paragraph 6(a)). They could include those that relate to, for example:

- The form and content of financial statements;
- Industry-specific financial reporting issues;
- Accounting for transactions under government contracts; or
- The accrual or recognition of expenses for income tax or pension costs.

Some provisions in those laws and regulations may be directly relevant to specific assertions in the financial statements (e.g., the completeness of income tax provisions), while others may be directly relevant to the financial statements as a whole (e.g., the required statements constituting a complete set of financial statements). The aim of the requirement in paragraph 14 is for the auditor to obtain sufficient appropriate audit evidence regarding the determination of amounts and disclosures in the financial statements in compliance with the relevant provisions of those laws and regulations.

Non-compliance with other provisions of such laws and regulations and other laws and regulations may result in fines, litigation or other consequences for the entity, the costs of which may need to be provided for in the financial statements, but are not considered to have a direct effect on the financial statements as described in paragraph 6(a).

Procedures to Identify Instances of Non-Compliance—Other Laws and Regulations (Ref: Para. 6, 15)

A13. Certain other laws and regulations may need particular attention by the auditor because they have a fundamental effect on the operations of the entity (as described in paragraph 6(b)). Non-compliance with laws and regulations that have a fundamental effect on the operations of the entity may cause the entity to cease operations, or call into question the entity's continuance as a going concern.[12] For example, non-compliance with the requirements of the entity's license or other entitlement to perform its operations could have such an impact (e.g., for a bank, non-compliance with capital or investment requirements). There are also many laws and regulations relating principally to the operating aspects of the entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.

A14. As the financial reporting consequences of other laws and regulations can vary depending on the entity's operations, the audit procedures required by paragraph 15 are directed to bringing to the auditor's attention instances of non-compliance with laws and regulations that may have a material effect on the financial statements.

Non-Compliance Brought to the Auditor's Attention by Other Audit Procedures (Ref: Para. 16)

A15. Audit procedures applied to form an opinion on the financial statements may bring instances of non-compliance or suspected non-compliance with laws and regulations to the auditor's attention. For example, such audit procedures may include:

[12] See HKSA 570 (Revised), *Going Concern*.

- Reading minutes;
- Inquiring of the entity's management and in-house legal counsel or external legal counsel concerning litigation, claims and assessments; and
- Performing substantive tests of details of classes of transactions, account balances or disclosures.

Written Representations (Ref: Para. 17)

A16. Because the effect on financial statements of laws and regulations can vary considerably, written representations provide necessary audit evidence about management's knowledge of identified or suspected non-compliance with laws and regulations, whose effects may have a material effect on the financial statements. However, written representations do not provide sufficient appropriate audit evidence on their own and, accordingly, do not affect the nature and extent of other audit evidence that is to be obtained by the auditor.[13]

Audit Procedures When Non-Compliance Is Identified or Suspected

Indications of Non-Compliance with Laws and Regulations (Ref: Para. 19)

A17. The auditor may become aware of information concerning an instance of non-compliance with laws and regulations other than as a result of performing the procedures in paragraphs 13–17 (e.g., when the auditor is alerted to non-compliance by a whistle blower).

A18. The following matters may be an indication of non-compliance with laws and regulations:

- Investigations by regulatory organizations and government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer or transfers to numbered bank accounts.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorized transactions or improperly recorded transactions.
- Adverse media comment.

[13] HKSA 580, *Written Representations*, paragraph 4

Matters Relevant to the Auditor's Evaluation (Ref: Para. 19(b))

A19. Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

- The potential financial consequences of identified or suspected non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, threat of expropriation of assets, enforced discontinuation of operations, and litigation.
- Whether the potential financial consequences require disclosure.
- Whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading.

Audit Procedures and Communicating Identified or Suspected Non-Compliance with Management and Those Charged with Governance (Ref: Para. 20)

A20. The auditor is required to discuss the suspected non-compliance with the appropriate level of management and, where appropriate, those charged with governance, as they may be able to provide additional audit evidence. For example, the auditor may confirm that management and, where appropriate, those charged with governance have the same understanding of the facts and circumstances relevant to transactions or events that have led to the suspected non-compliance with laws and regulations.

A21. However, in some jurisdictions, law or regulation may restrict the auditor's communication of certain matters with management and those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report the identified or suspected non-compliance to an appropriate authority pursuant to anti-money laundering legislation.[13a] In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice.

A22. If management or, as appropriate, those charged with governance do not provide sufficient information to the auditor that the entity is in fact in compliance with laws and regulations, the auditor may consider it appropriate to consult with the entity's in-house or external legal counsel about the application of the laws and regulations to the circumstances, including the possibility of fraud, and the possible effects on the financial statements. If it is not considered appropriate to consult with the entity's legal counsel or if the auditor is not satisfied with the legal counsel's opinion, the auditor may consider it appropriate to consult on a confidential basis with others within the firm, a network firm, a professional body, or with the auditor's legal counsel as to whether a contravention of a law or regulation is involved, including the possibility of fraud, the possible legal consequences, and what further action, if any, the auditor would take.

[13a] Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

Evaluating the Implications of Identified or Suspected Non-Compliance (Ref: Para. 22)

A23. As required by paragraph 22, the auditor evaluates the implications of identified or suspected non-compliance in relation to other aspects of the audit, including the auditor's risk assessment and the reliability of written representations. The implications of particular identified or suspected non-compliance will depend on the relationship of the perpetration and concealment, if any, of the act to specific control activities and the level of management or individuals working for, or under the direction of, the entity involved, especially implications arising from the involvement of the highest authority within the entity. As noted in paragraph 9, the auditor's compliance with law, regulation or relevant ethical requirements may provide further information that is relevant to the auditor's responsibilities in accordance with paragraph 22.

A24. Examples of circumstances that may cause the auditor to evaluate the implications of identified or suspected non-compliance on the reliability of written representations received from management and, where applicable, those charged with governance include when:

- The auditor suspects or has evidence of the involvement or intended involvement of management and, where applicable, those charged with governance in any identified or suspected non-compliance.
- The auditor is aware that management and, where applicable, those charged with governance have knowledge of such non-compliance and, contrary to legal or regulatory requirements, have not reported, or authorized reporting of, the matter to an appropriate authority within a reasonable period.

A25. In certain circumstances, the auditor may consider withdrawing from the engagement, where permitted by law or regulation, for example when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances or the identified or suspected non-compliance raises questions regarding the integrity of management or those charged with governance, even when the non-compliance is not material to the financial statements. The auditor may consider it appropriate to obtain legal advice to determine whether withdrawal from the engagement is appropriate. When the auditor determines that withdrawing from the engagement would be appropriate, doing so would not be a substitute for complying with other responsibilities under law, regulation or relevant ethical requirements to respond to identified or suspected non-compliance. Furthermore, paragraph A8a of HKSA 220[14] indicates that some ethical requirements may require the predecessor auditor, upon request by the proposed successor auditor, to provide information regarding non-compliance with laws and regulations to the successor auditor.

Communicating and Reporting Identified or Suspected Non-Compliance

Potential Implications of Identified or Suspected Non-Compliance for the Auditor's Report (Ref: Para. 26–28)

A26. Identified or suspected non-compliance with laws and regulation is communicated in the auditor's report when the auditor modifies the opinion in accordance with paragraphs 26–28. In certain other circumstances, the auditor may communicate identified or suspected non-compliance in the auditor's report, for example:

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

- When the auditor has other reporting responsibilities, in addition to the auditor's responsibilities under the HKSAs, as contemplated by paragraph 43 of HKSA 700 (Revised);
- When the auditor determines that the identified or suspected non-compliance is a key audit matter and accordingly communicates the matter in accordance with HKSA 701,[15] unless paragraph 14 of that HKSA applies; or
- In exceptional cases when management or those charged with governance do not take the remedial action that the auditor considers appropriate in the circumstances and withdrawal from the engagement is not possible (see paragraph A25), the auditor may consider describing the identified or suspected non-compliance in an Other Matter paragraph in accordance with HKSA 706 (Revised).[16]

A27. Law or regulation may preclude public disclosure by either management, those charged with governance or the auditor about a specific matter. For example, law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including a prohibition on alerting the entity. When the auditor intends to communicate identified or suspected non-compliance in the auditor's report under the circumstances set out in paragraph A26 or otherwise, such law or regulation may have implications for the auditor's ability to describe the matter in the auditor's report, or in some circumstances to issue the auditor's report. In such cases, the auditor may consider obtaining legal advice to determine the appropriate course of action.

Reporting Identified or Suspected Non-Compliance to an Appropriate Authority outside the Entity[16a] (Ref: Para. 29)

A28. Reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be required or appropriate in the circumstances because:

(a) Law, regulation or relevant ethical requirements require the auditor to report (see paragraph A29);

(b) The auditor has determined reporting is an appropriate action to respond to identified or suspected non-compliance in accordance with relevant ethical requirements (see paragraph A30); or

(c) Law, regulation or relevant ethical requirements provide the auditor with the right to do so (see paragraph A31).

A29. In some jurisdictions, the auditor may be required by law, regulation or relevant ethical requirements to report identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity. For example, in some jurisdictions, statutory requirements exist for the auditor of a financial institution to report the occurrence, or suspected occurrence, of non-compliance with laws and regulations to a supervisory authority. Also, misstatements may arise from non-compliance with laws or regulations and, in some

[15] HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

[16] HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

[16a] Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

jurisdictions, the auditor may be required to report misstatements to an appropriate authority in cases where management or those charged with governance fail to take corrective action.

A30. In other cases, the relevant ethical requirements may require the auditor to determine whether reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity is an appropriate action in the circumstances. For example, the Code requires the auditor to take steps to respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed, which may include reporting to an appropriate authority outside the entity.[17] The Code explains that such reporting would not be considered a breach of the duty of confidentiality under the Code.[18]

A31. Even if law, regulation or relevant ethical requirements do not include requirements that address reporting identified or suspected non-compliance, they may provide the auditor with the right to report identified or suspected non-compliance to an appropriate authority outside the entity. For example, when auditing the financial statements of financial institutions, the auditor may have the right under law or regulation to discuss matters such as identified or suspected non-compliance with laws and regulations with a supervisory authority.

A32. In other circumstances, the reporting of identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be precluded by the auditor's duty of confidentiality under law, regulation or relevant ethical requirements.

A33. The determination required by paragraph 29 may involve complex considerations and professional judgments. Accordingly the auditor may consider consulting internally (e.g., within the firm or a network firm) or on a confidential basis with a regulator or professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality). The auditor may also consider obtaining legal advice to understand the auditor's options and the professional or legal implications of taking any particular course of action.

Considerations Specific to Public Sector Entities

A34. A public sector auditor may be obliged to report on identified or suspected non-compliance to the legislature or other governing body or to report them in the auditor's report.

Documentation (Ref: Para. 30)

A35. The auditor's documentation of findings regarding identified or suspected non-compliance with laws and regulations may include, for example:

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

A36. Law, regulation or relevant ethical requirements may also set out additional documentation requirements regarding identified or suspected non-compliance with laws and regulations.[19]

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17 See, for example, Section 225.29 and Sections 225.33–225.36 of the Code.

18 See, for example, Section 140.7 and Section 225.35 of the Code.

19 See, for example, Section 225.37 of the Code.

CONFORMING AMENDMENTS TO OTHER HONG KONG STANDARDS

Note: The following are conforming amendments to other Hong Kong Standards as a result of the approval of HKSA 250 (Revised). These amendments will become effective at the same time as HKSA 250 (Revised), and are shown with marked changes from the latest approved versions of the Hong Kong Standards that are amended. The footnote numbers within these amendments do not align with the Hong Kong Standards that are amended, and reference should be made to those Hong Kong Standards. These conforming amendments align with those conforming amendments as a result of ISA 250 (Revised), which have received the approval of the PIOB which concluded that due process was followed in the development of the conforming amendments and that proper regard was paid to the public interest.

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

Application and Other Explanatory Material

Confidentiality, Safe Custody, Integrity, Accessibility and Retrievability of Engagement Documentation (Ref: Para. 46)

A56. Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information, or there are responsibilities under law, regulation or relevant ethical requirements ~~is a legal or professional duty~~ to do so.[20] Specific laws~~s~~ or regulations~~s~~ may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

HKSA 210, *Agreeing the Terms of Audit Engagements*

Application and Other Explanatory Material

Agreement on Audit Engagement Terms

A26. When relevant, the following points could also be made in the audit engagement letter:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- A reference to, and description of, the auditor's responsibilities under law, regulation or relevant ethical requirements that address reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

[20] See, for example, Section 140.7 and Section 225.35 of the Code.

An example of an audit engagement letter is set out in Appendix 1.

HKSA 220, *Quality Control for an Audit of Financial Statements*

Application and Other Explanatory Material

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

A8a. Law, regulation, or relevant ethical requirements[21] may require the auditor to request, prior to accepting the engagement, the predecessor auditor to provide known information regarding any facts or circumstances that, in the predecessor auditor's judgment, the auditor needs to be aware of before deciding whether to accept the engagement. In some circumstances, the predecessor auditor may be required, on request by the proposed successor auditor, to provide information regarding identified or suspected non-compliance with laws and regulations to the proposed successor auditor. For example, where the predecessor auditor has withdrawn from the engagement as a result of identified or suspected non-compliance with laws and regulations, the Code requires that the predecessor auditor, on request by a proposed successor auditor, provides all such facts and other information concerning such non-compliance that, in the predecessor auditor's opinion, the proposed successor auditor needs to be aware of before deciding whether to accept the audit appointment.[22]

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

Introduction

Responsibility for the Prevention and Detection of Fraud

Responsibilities of the Auditor

8a. The auditor may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, including fraud, which may differ from or go beyond this and other HKSAs, such as: (Ref: Para. A5a)

(a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance, assessing the appropriateness of their response to non-compliance and determining whether further action is needed;

(b) Communicating identified or suspected non-compliance with laws and regulations to other auditors (e.g., in an audit of group financial statements); and

(c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to the auditor's work in accordance with this and other HKSAs (e.g., regarding the integrity of management or, where appropriate, those charged with governance).

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[21] See, for example, Section 210.14 of the Code.

[22] See, for example, Section 225.31 of the Code.

Requirements

Communications to Management and with Those Charged with Governance

40. If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters, unless prohibited by law or regulation, on a timely basis with~~to~~ the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref: Para. A59a–A60)

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

    (a) management;

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

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

    the auditor shall communicate these matters with~~to~~ those charged with governance on a timely basis. If the auditor suspects fraud involving management, the auditor shall communicate these suspicions with~~to~~ those charged with governance and discuss with them the nature, timing and extent of audit procedures necessary to complete the audit. Such communications with those charged with governance are required unless the communication is prohibited by law or regulation. (Ref: Para. A59a, A61–A63)

42. The auditor shall communicate, unless prohibited by law or regulation, with those charged with governance any other matters related to fraud that are, in the auditor's judgment, relevant to their responsibilities. (Ref: Para. A59a, A64)

~~Communications to Regulatory and Enforcement Authorities~~Reporting Fraud to an Appropriate Authority Outside the Entity

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

    (a) Require the auditor to report to an appropriate authority outside the entity.

    (b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

Application and Other Explanatory Material

Responsibility for the Prevention and Detection of Fraud

Responsibilities of the Auditor (Ref: Para. 8a)

A5a. Law, regulation or relevant ethical requirements may require the auditor to perform additional procedures and take further actions. For example, the HKICPA's *Code of Ethics for Professional Accountants* (the Code) requires the auditor to take steps to respond to identified or suspected non-compliance with laws and regulations and determine whether further action is needed. Such steps may include the communication of identified or suspected non-compliance with laws and regulations to other auditors within a group, including a group engagement partner, component auditors or other auditors performing work at components of a group for purposes other than the audit of the group financial statements.[23]

Communications to Management and with Those Charged with Governance (Ref: Para. 40–42)

A59a. In some jurisdictions, law or regulation may restrict the auditor's communication of certain matters with management and those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report the fraud to an appropriate authority pursuant to anti-money laundering legislation.[23a] In these circumstances, the issues considered by the auditor may be complex and the auditor may consider it appropriate to obtain legal advice.

~~Communications to Regulatory and Enforcement Authorities~~Reporting Fraud to an Appropriate Authority outside the Entity (Ref: Para. 43)

A65. HKSA 250 (Revised)[24] provides further guidance with respect to the auditor's determination of whether reporting identified or suspected non-compliance with laws or regulations to an appropriate authority outside the entity is required or appropriate in the circumstances, including consideration of the auditor's duty of confidentiality. ~~The auditor's professional duty to maintain the confidentiality of client information may preclude reporting fraud to a party outside the client entity. However, the auditor's legal responsibilities vary by country and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law or courts of law. In some countries, the auditor of a financial institution has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some countries the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.~~

A66. The determination required by paragraph 43 may involve complex considerations and professional judgments. Accordingly, t~~T~~he auditor may consider consulting internally (e.g., within the firm or a network firm) or on a confidential basis with a regulator or professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality). The auditor may also consider~~ it appropriate to~~ obtaining legal advice to understand the auditor's options and the professional or legal implications of taking any particular ~~determine the appropriate~~ course of action~~ in the circumstances, the purpose of which is to ascertain the steps necessary in considering the public interest aspects of identified fraud~~.

HKSA 260 (Revised), *Communication with Those Charged with Governance*

Introduction

The Role of Communication

7. In some jurisdictions, ~~L~~law or regulation may restrict the auditor's communication of certain matters with those charged with governance. ~~For example, l~~Laws~~s~~ or regulations~~s~~ may specifically

[23] See Sections 225.21–225.22 of the Code.

[23a] Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

[24] HKSA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraphs A28–A34

prohibit a communication[24a], or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report identified or suspected non-compliance with laws and regulations to an appropriate authority pursuant to anti-money laundering legislation.[24b] In ~~some~~ these circumstances, the issues considered by the auditor ~~potential conflicts between the auditor's obligations of confidentiality and obligations to communicate~~ may be complex~~. In such cases,~~ and the auditor may consider it appropriate to obtain~~ing~~ legal advice.

HKSA 450, *Evaluation of Misstatements Identified During the Audit*

Requirements

Communication and Correction of Misstatements

8. The auditor shall communicate, unless prohibited by law or regulation, on a timely basis all misstatements accumulated during the audit with the appropriate level of management~~, unless prohibited by law or regulation~~.[25] The auditor shall request management to correct those misstatements. (Ref: Para. A7–A9)

Application and Other Explanatory Material

Communication and Correction of Misstatements (Ref: Para. 8–9)

A11. In some jurisdictions, l~~L~~aw or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. ~~For example,~~ L~~l~~aw~~s~~ or regulation~~s~~ may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the auditor is required to report identified or suspected non-compliance with law or regulation to an appropriate authority pursuant to anti-money laundering legislation.[25a] In ~~some~~these circumstances, ~~potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases,~~the issues considered by the auditor may be complex and the auditor may consider ~~seeking~~it appropriate to obtain legal advice.

HKSA 500, *Audit Evidence*

Requirements

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26–A33a)

Application and Other Explanatory Material

[24a] In Hong Kong, section 378 of the Securities and Futures Ordinance imposes a duty of secrecy upon the auditor of a licensed corporation. Application of section 378 will prevent the auditor from communicating certain matters to any parties other than the Securities and Futures Commission except under certain circumstances. Further guidance is set out in PN 820 (Revised), *The Audit of Licensed Corporations and Associated Entities of Intermediaries*.

[24b] Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

[25] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 7

[25a] Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

Information to Be Used as Audit Evidence

Relevance and Reliability (Ref: Para. 7)

A26. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, ~~and~~ a firm's quality control procedures for client acceptance and continuance and complying with certain additional responsibilities under law, regulation or relevant ethical requirements (e.g., regarding an entity's non-compliance with laws and regulations). The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

A33a. HKSA 250 (Revised)[26] provides further guidance with respect to the auditor complying with any additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's identified or suspected non-compliance with laws and regulations that may provide further information that is relevant to the auditor's work in accordance with HKSAs and evaluating the implications of such non-compliance in relation to other aspects of the audit.

HKSRE 2400 (Revised), *Engagements to Review Historical Financial Statements*

Requirements

Performing the Engagement

Designing and Performing Procedures

48. The practitioner's inquiries of management and others within the entity, as appropriate, shall include the following: (Ref: Para. A84–A87a)

…

(d) The existence of any actual, suspected or alleged:

(i) Fraud or illegal acts affecting the entity; and

(ii) Non-compliance with provisions of laws and regulations that are generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements, such as tax and pension laws and regulations;

Fraud and non-compliance with laws and~~or~~ regulations

52. When there is an indication that fraud or non-compliance with laws and~~or~~ regulations, or suspected fraud or non-compliance with laws and~~or~~ regulations, has occurred in the entity, the practitioner shall:

(a) Communicate that matter, unless prohibited by law or regulation, with ~~to~~ the appropriate level of ~~senior~~ management or those charged with governance as appropriate; (Ref: Para. A91a)

(b) Request management's assessment of the effect(s), if any, on the financial statements;

[26] HKSA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 9

(c) Consider the effect, if any, of management's assessment of the effects of identified or suspected fraud or non-compliance with laws and~~or~~ regulations communicated to the practitioner on the practitioner's conclusion on the financial statements and on the practitioner's report; and

(d) Determine whether law, regulation or relevant ethical requirements:~~there is a responsibility to report the occurrence or suspicion of fraud or illegal acts to a party outside the entity.~~ (Ref: Para. A92–A92d)

(i) Require the practitioner to report to an appropriate authority outside the entity.

(ii) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

Application and Other Explanatory Material

Performing the Engagement

Designing and Performing Procedures (Ref: Para. 47, 55)

Inquiry (Ref: Para. 46–48)

A87a. The practitioner may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, including fraud, which may differ from or go beyond this HKSRE, such as:

(a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance and considering whether further action is needed;

(b) Communicating identified or suspected non-compliance with laws and regulations to an auditor, for example a group engagement partner;[27] and

(c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to the practitioner's work in accordance with this HKSRE (e.g., regarding the integrity of management or, where appropriate, those charged with governance).

Procedures to Address Specific Circumstances

Fraud and non-compliance with laws ~~or~~and regulations (Ref: Para. 52(a) and (d))

Communication with management and those charged with governance

A91a. In some jurisdictions, law or regulation may restrict the practitioner's communication of certain matters with management or those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the practitioner is required to report identified or suspected non-compliance with laws and regulations to an appropriate authority pursuant to anti-money laundering

[27] See, for example, Sections 225.44–225.48 of the Code.

legislation.[27a] In these circumstances, the issues considered by the practitioner may be complex and the practitioner may consider it appropriate to obtain legal advice.

Reporting of identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity

A92. ~~Under this HKSRE, if the practitioner has identified or suspects fraud or illegalacts, the practitioner is required to determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity.~~ Reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be required or appropriate in the circumstances because:

(a) Law, regulation or relevant ethical requirements require the practitioner to report;

(b) The practitioner has determined reporting is an appropriate action to respond to identified or suspected non-compliance in accordance with relevant ethical requirements (see paragraph A92a); or

(c) Law, regulation or relevant ethical requirements provide the practitioner with the right to do so (see paragraph A92b).

~~Although the practitioner's professional duty to maintain the confidentiality of client information may preclude such reporting, the practitioner's legal responsibilities may override the duty of confidentiality in some circumstances.~~

A92a. In some cases, the relevant ethical requirements may require the practitioner to report or to consider whether reporting identified or suspected fraud or non-compliance with laws and regulations to an appropriate authority outside the entity is an appropriate action in the circumstances. For example, the Code requires the practitioner to take steps to respond to identified or suspected non-compliance with laws and regulations, and consider whether further action is needed, which may include reporting to an appropriate authority outside the entity.[28] The Code explains that such reporting would not be considered a breach of the duty of confidentiality under the Code.[29]

A92b. Even if law, regulation or relevant ethical requirements do not include requirements that address reporting identified or suspected non-compliance, they may provide the practitioner with the right to report identified or suspected fraud or non-compliance with laws and regulations to an appropriate authority outside the entity.

A92c. In other circumstances, the reporting of identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be precluded by the practitioner's duty of confidentiality under law, regulation or relevant ethical requirements.

A92d. The determination required by paragraph 52(d) may involve complex considerations and professional judgments. Accordingly, the practitioner may consider consulting internally (e.g., within the firm or a network firm) or on a confidential basis with a regulator or a professional body (unless doing so is prohibited by law or regulation or would breach the duty of confidentiality). The practitioner may also consider obtaining legal advice to understand the

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27a Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

28 See, for example, Sections 225.51-225.52 of the Code.

29 See, for example, Section 140.7 and Section 225.53 of the Code.

practitioner's options and the professional or legal implications of taking any particular course of action.

HKSAE 3000 (Revised), *Assurance Engagements other than Audits or Reviews of Historical Financial Information*

Requirements

Planning and Performing the Engagement

Understanding the Underlying Subject Matter and Other Engagement Circumstances

45. The practitioner shall make inquiries of the appropriate party(ies) regarding:

  (a) Whether they have knowledge of any actual, suspected or alleged intentional misstatement or non-compliance with laws and regulations affecting the subject matter information; (Ref: Para. A101–A101a)

  (b) Whether the responsible party has an internal audit function and, if so, make further inquiries to obtain an understanding of the activities and main findings of the internal audit function with respect to the subject matter information; and

  (c) Whether the responsible party has used any experts in the preparation of the subject matter information.

Other Communication Responsibilities

78. The practitioner shall consider whether, pursuant to the terms of the engagement and other engagement circumstances, any matter has come to the attention of the practitioner that is to be communicated with the responsible party, the measurer or evaluator, the engaging party, those charged with governance or others. (Ref: Para. A192–A192f)

Application and Other Explanatory Material

Planning and Performing the Engagement

Understanding the Engagement Circumstances (Ref: Para. 45–47R)

A101a. The practitioner may have additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's non-compliance with laws and regulations, which may differ from or go beyond the practitioner's responsibilities under this HKSAE, such as:

  (a) Responding to identified or suspected non-compliance with laws and regulations, including requirements in relation to specific communications with management and those charged with governance and considering whether further action is needed;

  (b) Communicating identified or suspected non-compliance with laws and regulations to an auditor;[30] and

  (c) Documentation requirements regarding identified or suspected non-compliance with laws and regulations.

Complying with any additional responsibilities may provide further information that is relevant to the practitioner's work in accordance with this and any other HKSAE (e.g., regarding the integrity of the responsible party or those charged with governance). Paragraphs A192a–A192e

[30] See, for example, Sections 225.44–225.48 of the Code.

further address the practitioner's responsibilities under law, regulation or relevant ethical requirements regarding communicating and reporting identified or suspected non-compliance with laws and regulations.

Other Communication Responsibilities (Ref: Para. 78)

Communication with Management and Those Charged with Governance

A192a. Relevant ethical requirements may include a requirement to report identified or suspected non-compliance with laws and regulations to an appropriate level of management or those charged with governance. In some jurisdictions, law or regulation may restrict the practitioner's communication of certain matters with the responsible party, management or those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the practitioner is required to report the identified or suspected non-compliance to an appropriate authority pursuant to anti-money laundering legislation.[30a] In these circumstances, the issues considered by the practitioner may be complex and the practitioner may consider it appropriate to obtain legal advice.

Reporting of Identified or Suspected Non-Compliance with Laws and Regulations to an Appropriate Authority outside the Entity

A192b. Law, regulation or relevant ethical requirements may:

(a) Require the practitioner to report identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity.

(b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.[31]

A192c. Reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be required or appropriate in the circumstances because:

(a) Law, regulation or relevant ethical requirements require the practitioner to report;

(b) The practitioner has determined reporting is an appropriate action to respond to identified or suspected non-compliance in accordance with relevant ethical requirements; or~~.~~

(c) Law, regulation or relevant ethical requirements provide the practitioner with the right to do so.

A192d. The reporting of identified or suspected non-compliance with laws and regulations in accordance with law, regulation or relevant ethical requirements may include non-compliance with laws and regulations that the practitioner comes across or is made aware of when performing the engagement but which may not affect the subject matter information. Under this HKSAE, the practitioner is not expected to have a level of understanding of laws and regulations beyond those affecting the subject matter information. However, law, regulation or relevant ethical requirements may expect the practitioner to apply knowledge, professional judgment and expertise in responding to such non-compliance. Whether an act constitutes

[30a] Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

[31] See, for example, Sections 225.51-225.52 of the Code.

actual non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

A192e. In some circumstances, the reporting of identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be precluded by the practitioner's duty of confidentiality under law, regulation, or relevant ethical requirements. In other cases, reporting identified or suspected non-compliance to an appropriate authority outside the entity would not be considered a breach of the duty of confidentiality under the relevant ethical requirements.[32]

A192f. The practitioner may consider consulting internally (e.g., within the firm or network firm), obtaining legal advice to understand the professional or legal implications of taking any particular course of action, or consulting on a confidential basis with a regulator or a professional body (unless doing so is prohibited by law or regulations or would breach the duty of confidentiality).[33]

HKSAE 3402, *Assurance Reports on Controls at a Service Organization*

Requirements

Other Communication Responsibilities

56. If the service auditor becomes aware of non-compliance with laws and regulations, fraud, or uncorrected errors attributable to the service organization that are not clearly trivial and may affect one or more user entities, the service auditor shall determine whether the matter has been communicated appropriately to affected user entities. If the matter has not been so communicated and the service organization is unwilling to do so, the service auditor shall take appropriate action. (Ref: Para. A53)

Application and Other Explanatory Material

Other Communication Responsibilities (Ref: Para. 56)

A53. Appropriate actions to respond to the circumstances identified in paragraph 56, unless prohibited by law or regulation, may include:

- Obtaining legal advice about the consequences of different courses of action.
- Communicating with those charged with governance of the service organization.
- Determining whether to communicate with third parties (e.g., law, regulation or relevant ethical requirements may require the service auditor to report to an appropriate authority outside the entity or the external auditor of the service organization,[34] or establish responsibilities under which such reporting may be appropriate in the circumstances).~~Communicating with third parties (for example, a regulator) when required to do so.~~
- Modifying the service auditor's opinion, or adding an Other Matter paragraph.
- Withdrawing from the engagement.

[32] See, for example, Section 140.7 and Section 225.53 of the Code.

[33] See, for example, Section 225.55 of the Code.

[34] See, for example, Sections 225.44-225.48 of the Code.

HKSAE 3410, *Assurance Engagements on Greenhouse Gas Statements*

Requirements

Other Communication Responsibilities

78. The practitioner shall communicate, unless prohibited by law or regulation, with ~~to~~ those person(s) with oversight responsibilities for the GHG statement the following matters that come to the practitioner's attention during the course of the engagement, and shall determine whether there is a responsibility to report them to another party within or outside the entity:

    (a) Deficiencies in internal control that, in the practitioner's professional judgment, are of sufficient importance to merit attention;

    (b) Identified or suspected fraud; and

    (c) Matters involving identified or suspected non-compliance with laws and~~or~~ regulations, other than when the matters are clearly trivial. (Ref: Para. A87)

HKSRS 4410 (Revised), *Compilation Engagements*

Requirements

Ethical Requirements

21. The practitioner shall comply with relevant ethical requirements. (Ref: Para. A19–A21e)

Communication with Management and Those Charged with Governance

27. The practitioner shall communicate with management or those charged with governance, as appropriate, on a timely basis during the course of the compilation engagement, all matters concerning the compilation engagement that, in the practitioner's professional judgment, are of sufficient importance to merit the attention of management or those charged with governance, as appropriate. (Ref: Para. A41–A41a)

Ethical Requirements (Ref: Para. 21)

Reporting of Identified or Suspected Non-Compliance with Laws and Regulations to an Appropriate Authority outside the Entity

A21a. Law, regulation or relevant ethical requirements may:

(a) Require the practitioner to report identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity.

(b) Establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.[35]

A21b. Reporting identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be required or appropriate in the circumstances because:

(a) Law, regulation or relevant ethical requirements require the practitioner to report;

(b) The practitioner has determined reporting is an appropriate action to respond to identified or suspected non-compliance in accordance with relevant ethical requirements; or

[35] See, for example, Sections 225.51-225.52 of the Code.

(c) Law, regulation or relevant ethical requirements provide the practitioner with the right to do so.

A21c. Under paragraph 28 of this HKSRS, the practitioner is not expected to have a level of understanding of laws and regulations beyond that necessary to be able to perform the compilation engagement. However, law, regulation or relevant ethical requirements may expect the practitioner to apply knowledge, professional judgment and expertise in responding to identified or suspected non-compliance. Whether an act constitutes actual non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

A21d. In some circumstances, the reporting of identified or suspected non-compliance with laws and regulations to an appropriate authority outside the entity may be precluded by the practitioner's duty of confidentiality under law, regulation or relevant ethical requirements. In other cases, reporting identified or suspected non-compliance to an appropriate authority outside the entity would not be considered a breach of the duty of confidentiality under the relevant ethical requirements.[36]

A21e. The practitioner may consider consulting internally (e.g., within the firm or network firm), obtaining legal advice to understand the professional or legal implications of taking any particular course of action, or consulting on a confidential basis with a regulator or a professional body (unless doing so is prohibited by law or regulations or would breach the duty of confidentiality).[37]

Communication with Management and Those Charged with Governance (Ref: Para. 27)

A41a. Relevant ethical requirements may include a requirement to report identified or suspected non-compliance with laws and regulations to an appropriate level of management or those charged with governance. In some jurisdictions, law or regulation may restrict the practitioner's communication of certain matters with management or those charged with governance. Law or regulation may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act, including alerting the entity, for example, when the practitioner is required to report the identified or suspected non-compliance to an appropriate authority pursuant to anti-money laundering legislation.[37a] In these circumstances, the issues considered by the practitioner may be complex and the practitioner may consider it appropriate to obtain legal advice.

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[36] See, for example, Section 140.7 and Section 225.53 of the Code.

[37] See, for example, Section 225.55 of the Code.

[37a] Additional guidance is provided in Appendix 4 of HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.

HKSA 260 (Revised)

Issued August 2015; revised January 2016, June 2017

Effective for audits of financial statements
for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 260 (Revised)

Communication with Those Charged with Governance

Hong Kong Institute of
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香港會計師公會

would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A46–A48)

20. The auditor shall communicate in writing with those charged with governance regarding auditor independence when required by paragraph 17.

Timing of Communications

21. The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A49–A50)

Adequacy of the Communication Process

22. The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A51–A53)

Documentation

23. Where matters required by this HKSA to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation.[2] (Ref: Para. A54)

Conformity and Compliance with International Standards on Auditing

24. As of August 2015 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 260 (Revised), *Communication with Those Charged with Governance*. Compliance with the requirements of this HKSA ensures compliance with ISA 260 (Revised).

25. Additional local guidance is provided in footnote 1a.

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Application and Other Explanatory Material

Those Charged with Governance (Ref: Para. 11)

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

- In some jurisdictions, a supervisory (wholly or mainly non-executive) board exists that is legally separate from an executive (management) board (a "two-tier board" structure). In other jurisdictions, both the supervisory and executive functions are the legal responsibility of a single, or unitary, board (a "one-tier board" structure).
- In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. In others, for example, some government entities, a body that is not part of the entity is charged with governance.

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

- In some cases, some or all of those charged with governance are involved in managing the entity. In others, those charged with governance and management comprise different persons.
- In some cases, those charged with governance are responsible for approving[3] the entity's financial statements (in other cases management has this responsibility).

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

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

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

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

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

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.

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3 As described in paragraph A68 of HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, having responsibility for approving in this context means having the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared.

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

5 HKSA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, paragraph 49

- The auditor's planned approach to addressing the implications on the individual statements and the disclosures of any significant changes within the applicable financial reporting framework or in the entity's environment, financial condition or activities.

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

- Where the entity has an internal audit function, how the external auditor and internal auditors can work together in a constructive and complementary manner, including any planned use of the work of the internal audit function, and the nature and extent of any planned use of internal auditors to provide direct assistance.[10]
- The views of those charged with governance about:
  - The appropriate person(s) in the entity's governance structure with whom to communicate.
  - The allocation of responsibilities between those charged with governance and management.
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - Significant communications between the entity and regulators.
  - Other matters those charged with governance consider may influence the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control, and (b) the detection or possibility of fraud.
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices , exchange listing rules, and related matters, and the effect of such developments on, for example, the overall presentation, structure and content of the financial statements, including:
  - The relevance, reliability, comparability and understandability of the information presented in the financial statements; and
  - Considering whether the financial statements are undermined by the inclusion of information that is not relevant or that obscures a proper understanding of the matters disclosed.
- The responses of those charged with governance to previous communications with the auditor.

[10] HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraphs 20 and 31

- The documents comprising the other information (as defined in HKSA 720 (Revised)) and the planned manner and timing of the issuance of such documents. When the auditor expects to obtain other information after the date of the auditor's report, the discussions with those charged with governance may also include the actions that may be appropriate or necessary if the auditor concludes that a material misstatement of the other information exists in other information obtained after the date of the auditor's report.

A15. While communication with those charged with governance may assist the auditor to plan the scope and timing of the audit, it does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing and extent of procedures necessary to obtain sufficient appropriate audit evidence.

A16. Care is necessary when communicating with those charged with governance about the planned scope and timing of the audit so as not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

Significant Findings from the Audit (Ref: Para. 16)

A17. The communication of findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

A18. When HKSA 701 applies, the communications with those charged with governance required by paragraph 16, as well as the communication about the significant risks identified by the auditor required by paragraph 15, are particularly relevant to the auditor's determination of matters that required significant auditor attention and which therefore may be key audit matters.[11]

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(a))

A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of key assumptions in the development of accounting estimates for which there is significant measurement uncertainty. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

A20. As a result, the auditor's views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks. Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices and the quality of the disclosures. Appendix 2 identifies matters that may be included in this communication.

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[11] HKSA 701, paragraphs 9–10

governance about circumstances in which the auditor's report may differ from its expected form and content or may include additional information about the audit that was performed.

A24. Circumstances in which the auditor is required or may otherwise consider it necessary to include additional information in the auditor's report in accordance with the HKSAs, and for which communication with those charged with governance is required, include when:

- The auditor expects to modify the opinion in the auditor's report in accordance with HKSA 705 (Revised).[15]
- A material uncertainty related to going concern is reported in accordance with HKSA 570 (Revised).[16]
- Key audit matters are communicated in accordance with HKSA 701.[17]
- The auditor considers it necessary to include an Emphasis of Matter paragraph or Other Matters paragraph in accordance with HKSA 706 (Revised)[18] or is required to do so by other HKSAs.
- The auditor has concluded that there is an uncorrected material misstatement of the other information in accordance with HKSA 720 (Revised).[19]

In such circumstances, the auditor may consider it useful to provide those charged with governance with a draft of the auditor's report to facilitate a discussion of how such matters will be addressed in the auditor's report.

A25. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report in accordance with HKSA 700 (Revised), the auditor is required to discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat.[20] The auditor also may communicate with those charged with governance in circumstances when the auditor elects not to include the description of the auditor's responsibilities in the body of the auditor's report as permitted by HKSA 700 (Revised).[21]

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(e))

A26. HKSA 300[22] notes that, as a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. The auditor may communicate with those charged with governance about such matters, for example, as an update to initial discussions about the planned scope and timing of the audit.

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[15] HKSA 705 (Revised), paragraph 30

[16] HKSA 570 (Revised), *Going Concern*, paragraph 25(d)

[17] HKSA 701, paragraph 17

[18] HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph 12

[19] HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, paragraph 18(a)

[20] HKSA 700 (Revised), paragraphs 46 and A63

[21] HKSA 700 (Revised), paragraph 41

[22] HKSA 300, *Planning an Audit of Financial Statements*, paragraph A15

A27. Other significant matters arising during the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of the other information that have been corrected.

A28. To the extent not already addressed by the requirements in paragraphs 16(a)–(d) and related application material, the auditor may consider communicating about other matters discussed with, or considered by, the engagement quality control reviewer, if one has been appointed, in accordance with HKSA 220.[23]

Auditor Independence (Ref: Para. 17)

A29. The auditor is required to comply with relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements.[24]

A30. The relationships and other matters, and safeguards to be communicated, vary with the circumstances of the engagement, but generally address:

(a) Threats to independence, which may be categorized as: self-interest threats, self-review threats, advocacy threats, familiarity threats, and intimidation threats; and

(b) Safeguards created by the profession, legislation or regulation, safeguards within the entity, and safeguards within the firm's own systems and procedures.

A31. Relevant ethical requirements or law or regulation may also specify particular communications to those charged with governance in circumstances where breaches of independence requirements have been identified. For example, the HKICPA's *Code of Ethics for Professional Accountants* (the Code) requires the auditor to communicate with those charged with governance in writing about any breach and the action the firm has taken or proposes to take.[25]

A32. The communication requirements relating to auditor independence that apply in the case of listed entities may also be appropriate in the case of some other entities, including those that may be of significant public interest, for example because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities. On the other hand, there may be situations where communications regarding independence may not be relevant, for example, where all of those charged with governance have been informed of relevant facts through their management activities. This is particularly likely where the entity is owner-managed, and the auditor's firm and network firms have little involvement with the entity beyond a financial statement audit.

Supplementary Matters (Ref: Para. 3)

A33. The oversight of management by those charged with governance includes ensuring that the entity designs, implements and maintains appropriate internal control with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

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23 See paragraphs 19–22 and A23–A32 of HKSA 220, *Quality Control for an Audit of Financial Statements*.

24 HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 14

25 See Section 290.39–49 of the Code, which addresses breaches of independence.

- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters raised by the auditor, for example, the extent to which those charged with governance probe issues, and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.
- Whether the two-way communication between the auditor and those charged with governance meets applicable legal and regulatory requirements.

A52. As noted in paragraph 4, effective two-way communication assists both the auditor and those charged with governance. Further, HKSA 315 (Revised) identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment.[27] Inadequate two-way communication may indicate an unsatisfactory control environment and influence the auditor's assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

A53. If the two-way communication between the auditor and those charged with governance is not adequate and the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (e.g., a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (e.g., shareholders in a general meeting), or the responsible government minister or parliament in the public sector.
- Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

Documentation (Ref: Para. 23)

A54. Documentation of oral communication may include a copy of minutes prepared by the entity retained as part of the audit documentation where those minutes are an appropriate record of the communication.

[27] HKSA 315 (Revised), paragraph A78

Appendix 1

(Ref: Para. 3)

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

This appendix identifies paragraphs in HKSQC 1[1] and other HKSAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in HKSAs.

- HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* – paragraph 30(a)
- HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 21, 38(c)(i) and 40-42
- HKSA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 14, 19 and 22–24; HKSA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 15, 20 and 23-25
- HKSA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9
- HKSA 450, *Evaluation of Misstatements Identified during the Audit* – paragraphs 12-13
- HKSA 505, *External Confirmations* – paragraph 9
- HKSA 510, *Initial Audit Engagements—Opening Balances* – paragraph 7
- HKSA 550, *Related Parties* – paragraph 27
- HKSA 560, *Subsequent Events* – paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17
- HKSA 570 (Revised), *Going Concern* – paragraph 25
- HKSA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* – paragraph 49
- HKSA 610 (Revised 2013), *Using the Work of Internal Auditors* – paragraphs 20 and 31
- HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* – paragraph 46
- HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* – paragraph 17
- HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* – paragraphs 12, 14, 23 and 30
- HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* – paragraph 12
- HKSA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraph 18

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

HKSA 300
Issued June 2009; revised July 2010, December 2012, May 2013,
February 2015, January 2016, June 2017

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

Hong Kong Standard on Auditing 300

Planning an Audit of Financial Statements

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

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HONG KONG STANDARD ON AUDITING 300

PLANNING AN AUDIT OF FINANCIAL STATEMENTS

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

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Hong Kong Standard on Auditing (HKSA) 300, *Planning an Audit of Financial Statements*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to plan an audit of financial statements. This HKSA is written in the context of recurring audits. Additional considerations in an initial audit engagement are separately identified.

The Role and Timing of Planning

2. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan. Adequate planning benefits the audit of financial statements in several ways, including the following: (Ref: Para. A1-A3)

    - Helping the auditor to devote appropriate attention to important areas of the audit.
    - Helping the auditor identify and resolve potential problems on a timely basis.
    - Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
    - Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
    - Facilitating the direction and supervision of engagement team members and the review of their work.
    - Assisting, where applicable, in coordination of work done by auditors of components and experts.

Effective Date

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

Objective

4. The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Requirements

Involvement of Key Engagement Team Members

5. The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A4)

Preliminary Engagement Activities

6. The auditor shall undertake the following activities at the beginning of the current audit engagement:

   (a) Performing procedures required by HKSA 220 regarding the continuance of the client relationship and the specific audit engagement;[1]

   (b) Evaluating compliance with relevant ethical requirements, including independence, in accordance with HKSA 220;[2] and

   (c) Establishing an understanding of the terms of the engagement, as required by HKSA 210.[3] (Ref: Para. A5-A7)

Planning Activities

7. The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

8. In establishing the overall audit strategy, the auditor shall:

   (a) Identify the characteristics of the engagement that define its scope;

   (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;

   (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;

   (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

   (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A8-A11)

9. The auditor shall develop an audit plan that shall include a description of:

   (a) The nature, timing and extent of planned risk assessment procedures, as determined under HKSA 315 (Revised).[4]

   (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under HKSA 330.[5]

   (c) Other planned audit procedures that are required to be carried out so that the engagement complies with HKSAs. (Ref: Para. A12-A14)

10. The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A15)

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[1] HKSA 220, *Quality Control for an Audit of Financial Statements*, paragraphs 12-13

[2] HKSA 220, paragraphs 9-11

[3] HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraphs 9-13

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

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

11. The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A16-A17)

Documentation

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

    (a) The overall audit strategy;

    (b) The audit plan; and

    (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A18-A21)

Additional Considerations in Initial Audit Engagements

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

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

    (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A22)

Conformity and Compliance with International Standards on Auditing

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

* * *

Application and Other Explanatory Material

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

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

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

- The analytical procedures to be applied as risk assessment procedures.
- Obtaining a general understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with that framework.

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

[7] HKSA 220, paragraphs 12-13

- The determination of materiality.
- The involvement of experts.
- The performance of other risk assessment procedures.

A3. The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management may compromise the effectiveness of the audit by making the audit procedures too predictable.

Involvement of Key Engagement Team Members (Ref: Para. 5)

A4. The involvement of the engagement partner and other key members of the engagement team in planning the audit draws on their experience and insight, thereby enhancing the effectiveness and efficiency of the planning process.[8]

Preliminary Engagement Activities (Ref: Para. 6)

A5. Performing the preliminary engagement activities specified in paragraph 6 at the beginning of the current audit engagement assists the auditor in identifying and evaluating events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement.

A6. Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which, for example:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

A7. The auditor's consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur. Performing initial procedures on both client continuance and evaluation of relevant ethical requirements (including independence) at the beginning of the current audit engagement means that they are completed prior to the performance of other significant activities for the current audit engagement. For continuing audit engagements, such initial procedures often occur shortly after (or in connection with) the completion of the previous audit.

8 HKSA 315 (Revised), paragraph 10, establishes requirements and provides guidance on the engagement team's discussion of the susceptibility of the entity to material misstatements of the financial statements. HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 15, provides guidance on the emphasis given during this discussion to the susceptibility of the entity's financial statements to material misstatement due to fraud.

Planning Activities

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

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

- The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;
- The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
- When these resources are to be deployed, such as whether at an interim audit stage or at key cutoff dates; and
- How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

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

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

Considerations Specific to Smaller Entities

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

The Audit Plan (Ref: Para. 9)

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

A13. Determining the nature, timing and extent of planned risk assessment procedures, and the further audit procedures, as they relate to disclosures is important in light of both the wide range of information and the level of detail that may be encompassed in those disclosures. Further, certain disclosures may contain information that is obtained from outside of the general and subsidiary ledgers, which may also affect the assessed risks and the nature, timing and extent of audit procedures to address them.

A14. Consideration of disclosures early in the audit assists the auditor in giving appropriate attention to, and planning adequate time for, addressing disclosures in the same way as classes of transactions, events and account balances. Early consideration may also help the auditor to determine the effects on the audit of:

- Significant new or revised disclosures required as a result of changes in the entity's environment, financial condition or activities (for example, a change in the required identification of segments and reporting of segment information arising from a significant business combination);
- Significant new or revised disclosures arising from changes in the applicable financial reporting framework;
- The need for the involvement of an auditor's expert to assist with audit procedures related to particular disclosures (for example, disclosures related to pension or other retirement benefit obligations); and
- Matters relating to disclosures that the auditor may wish to discuss with those charged with governance.[9]

Changes to Planning Decisions during the Course of the Audit (Ref: Para. 10)

A15. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures, based on the revised consideration of assessed risks. This may be the case when information comes to the auditor's attention that differs significantly from the information available when the auditor planned the audit procedures. For example, audit evidence obtained through the performance of substantive procedures may contradict the audit evidence obtained through tests of controls.

Direction, Supervision and Review (Ref: Para. 11)

A16. The nature, timing and extent of the direction and supervision of engagement team members and review of their work vary depending on many factors, including:

- The size and complexity of the entity.
- The area of the audit.

[9] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph A13

- The assessed risks of material misstatement (for example, an increase in the assessed risk of material misstatement for a given area of the audit ordinarily requires a corresponding increase in the extent and timeliness of direction and supervision of engagement team members, and a more detailed review of their work).

- The capabilities and competence of the individual team members performing the audit work.

HKSA 220 contains further guidance on the direction, supervision and review of audit work. [10]

Considerations Specific to Smaller Entities

A17. If an audit is carried out entirely by the engagement partner, questions of direction and supervision of engagement team members and review of their work do not arise. In such cases, the engagement partner, having personally conducted all aspects of the work, will be aware of all material issues. Forming an objective view on the appropriateness of the judgments made in the course of the audit can present practical problems when the same individual also performs the entire audit. If particularly complex or unusual issues are involved, and the audit is performed by a sole practitioner, it may be desirable to consult with other suitably-experienced auditors or the auditor's professional body.

Documentation (Ref: Para. 12)

A18. The documentation of the overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. For example, the auditor may summarize the overall audit strategy in the form of a memorandum that contains key decisions regarding the overall scope, timing and conduct of the audit.

A19. The documentation of the audit plan is a record of the planned nature, timing and extent of risk assessment procedures and further audit procedures at the assertion level in response to the assessed risks. It also serves as a record of the proper planning of the audit procedures that can be reviewed and approved prior to their performance. The auditor may use standard audit programs or audit completion checklists, tailored as needed to reflect the particular engagement circumstances.

A20. A record of the significant changes to the overall audit strategy and the audit plan, and resulting changes to the planned nature, timing and extent of audit procedures, explains why the significant changes were made, and the overall strategy and audit plan finally adopted for the audit. It also reflects the appropriate response to the significant changes occurring during the audit.

Considerations Specific to Smaller Entities

A21. As discussed in paragraph A11, a suitable, brief memorandum may serve as the documented strategy for the audit of a smaller entity. For the audit plan, standard audit programs or checklists (see paragraph A19) drawn up on the assumption of few relevant control activities, as is likely to be the case in a smaller entity, may be used provided that they are tailored to the circumstances of the engagement, including the auditor's risk assessments.

[10] HKSA 220, paragraphs 15-17

Additional Considerations in Initial Audit Engagements (Ref: Para. 13)

A22. The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not ordinarily have the previous experience with the entity that is considered when planning recurring engagements. For an initial audit engagement, additional matters the auditor may consider in establishing the overall audit strategy and audit plan include the following:

- Unless prohibited by law or regulation, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.

- Any major issues (including the application of accounting principles or of auditing and reporting standards) discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance and how these matters affect the overall audit strategy and audit plan.

- The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances.[11]

- Other procedures required by the firm's system of quality control for initial audit engagements (for example, the firm's system of quality control may require the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance).

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[11] HKSA 510, *Initial Audit Engagements — Opening Balances*

Appendix

(Ref: Para. 7-8, A8-A11)

Considerations in Establishing the Overall Audit Strategy

This appendix provides examples of matters the auditor may consider in establishing the overall audit strategy. Many of these matters will also influence the auditor's detailed audit plan. The examples provided cover a broad range of matters applicable to many engagements. While some of the matters referred to below may be required by other HKSAs, not all matters are relevant to every audit engagement and the list is not necessarily complete.

Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- Whether the entity has an internal audit function and if so, whether, in which areas and to what extent, the work of the function can be used, or internal auditors can be used to provide direct assistance, for purposes of the audit.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

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

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

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

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

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

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

- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.

- Changes within the applicable financial reporting framework, such as changes in accounting standards, which may involve significant new or revised disclosures.

- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.

- Importance attached to internal control throughout the entity to the successful operation of the business.

- The process(es) management uses to identify and prepare the disclosures required by the applicable financial reporting framework, including disclosures containing information that is obtained from outside of the general and subsidiary ledgers.

- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.

- Significant industry developments such as changes in industry regulations and new reporting requirements.

- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.

- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

HKSA 315 (Revised)
Revised July 2012, December 2012, January 2016, June 2017

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

Hong Kong Standard on Auditing 315 (Revised)

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

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

HONG KONG STANDARD ON AUDITING 315 (REVISED)

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

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

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

Introduction

Scope of this HKSA

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

Effective Date

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

Objective

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

Definitions

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

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

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

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

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

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

Requirements

Risk Assessment Procedures and Related Activities

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

6. The risk assessment procedures shall include the following:

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

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

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

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

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

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

10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A21–A24)

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

The Entity and Its Environment

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

    (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A25–A30)

    (b) The nature of the entity, including:

        (i) its operations;

        (ii) its ownership and governance structures;

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

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

to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A31–A35)

(c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A36)

(d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A37–A43)

(e) The measurement and review of the entity's financial performance. (Ref: Para. A44–A49)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50–A73)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A74–A76)

Components of Internal Control

Control environment

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

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

(b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A77–A87)

The entity's risk assessment process

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

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

(b) Estimating the significance of the risks;

(c) Assessing the likelihood of their occurrence; and

(d) Deciding about actions to address those risks. (Ref: Para. A88)

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

17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A89)

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

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (Ref: Para.A90–A92 and A95–A96)

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

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

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

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

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

    (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A93–A94)

    This understanding of the information system relevant to financial reporting shall include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers.

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A97–A98)

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

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

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A99–A106)

21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A107–A109)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A110–A112)

23. If the entity has an internal audit function,[1] the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A113–A120)

24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A121)

Identifying and Assessing the Risks of Material Misstatement

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

    (a) the financial statement level; and (Ref: Para. A122–A125)

    (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A126–A131)

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

26. For this purpose, the auditor shall:

    (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures (including the quantitative or qualitative aspects of such disclosures) in the financial statements; (Ref: Para. A132–A136)

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

    (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A137–A139)

    (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement could result in a material misstatement. (Ref: Para. A140)

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[1] HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 14(a), defines the term "internal audit function" for purposes of the HKSAs.

Risks that Require Special Audit Consideration

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

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

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

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

    (c) The complexity of transactions;

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

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

    (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A141–A145)

29. If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A146–A148)

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

30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A149–A151)

Revision of Risk Assessment

31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A152)

Documentation

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

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

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

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

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

(d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30. (Ref: Para. A153–A156)

Conformity and Compliance with International Standards on Auditing

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

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Application and Other Explanatory Material

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

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

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

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

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

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

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

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

- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.

- Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

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

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

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

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. HKSA 260 (Revised)[5] identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.

- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.

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

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

- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.

- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

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

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

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

Inquiries of the Internal Audit Function

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

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

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

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

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[6] The relevant requirements are contained in HKSA 610 (Revised 2013).

[7] HKSA 240, paragraph 19

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

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

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

A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

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

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

Considerations Specific to Smaller Entities

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

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

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

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

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

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

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
- Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example due to their complexity.

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

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

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

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

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

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[8] HKSA 240, paragraph 15

A22. As part of the discussion among the engagement team required by paragraph 10, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures. Examples of matters the engagement team may discuss include:

- Changes in financial reporting requirements that may result in significant new or revised disclosures;
- Changes in the entity's environment, financial condition or activities that may result in significant new or revised disclosures, for example, a significant business combination in the period under audit;
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past; and
- Disclosures about complex matters, including those involving significant management judgment as to what information to disclose.

A23. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A24. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

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

The Entity and Its Environment

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

Industry Factors

A25. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

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

A26. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience.[9]

Regulatory Factors

A27. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

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

A28. HKSA 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.[10]

Considerations specific to public sector entities

A29. For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other External Factors

A30. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

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

A31. An understanding of the nature of an entity enables the auditor to understand such matters as:

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

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

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

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

A32. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations such as:
  - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
  - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
  - Alliances, joint ventures, and outsourcing activities.
  - Geographic dispersion and industry segmentation.
  - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
  - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post- employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
  - Research and development activities and expenditures.
  - Transactions with related parties.
- Investments and investment activities such as:
  - Planned or recently executed acquisitions or divestitures.
  - Investments and dispositions of securities and loans.
  - Capital investment activities.
  - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- Financing and financing activities such as:
  - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.
  - Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
  - Beneficial owners (local, foreign, business reputation and experience) and related parties.

[11] HKSA 550, *Related Parties*

    ○ Use of derivative financial instruments.

- Financial reporting practices such as:

    ○ Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).

    ○ Revenue recognition.

    ○ Accounting for fair values.

    ○ Foreign currency assets, liabilities and transactions.

    ○ Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A33. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A34. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As HKSA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.[12]

A35. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

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

A36. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

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

[12] HKSA 550, paragraph A7

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

A37. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

A38. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change may also give rise to business risk. Business risk may arise, for example, from:

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

A39. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

A40. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
- Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
- Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

A41. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.

A42. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A88–A89.

Considerations Specific to Public Sector Entities

A43. For the audits of public sector entities, "management objectives" may be influenced by concerns regarding public accountability and may include objectives which have their source in law, regulation or other authority.

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

A44. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. See HKSA 240 for requirements and guidance in relation to the risks of fraud.

A45. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A110–A121), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).

- Monitoring of controls is specifically concerned with the effective operation of internal control.

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

A46. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.

- Period-on-period financial performance analyses.

- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.

- Employee performance measures and incentive compensation policies.

- Comparisons of an entity's performance with that of competitors.

A47. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

A48. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations Specific to Smaller Entities

A49. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

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

A50. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.

A51. The following application material on internal control is presented in four sections, as follows:

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

General Nature and Characteristics of Internal Control

Purpose of Internal Control

A52. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:

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

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

Considerations specific to smaller entities

A53. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of Internal Control

A54. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.

A55. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

A56. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

A57. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

A58. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of Internal Control into Components

A59. The division of internal control into the following five components, for purposes of the HKSAs, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:

(a) The control environment;

(b) The entity's risk assessment process;

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

(d) Control activities; and

(e) Monitoring of controls.

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

A60. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A77–A121 below. Appendix 1 provides further explanation of these components of internal control.

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

A61. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A62. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

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

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

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

A63. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;

- Enhance the timeliness, availability, and accuracy of information;

- Facilitate the additional analysis of information;

- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;

- Reduce the risk that controls will be circumvented; and

- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A64. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.

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

A65. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

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

A66. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

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

A67. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

A68. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.

A69. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:

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

A70. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.

A71. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.

A72. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

Considerations Specific to Public Sector Entities

A73. Public sector auditors often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice. Public sector auditors can also have responsibilities to report on compliance with law, regulation or other authority. As a result, their review of internal control may be broader and more detailed.

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

A74. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A75. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

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

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

A76. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A63), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in HKSA 330.[13]

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

A77. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A78. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

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

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

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

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

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

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

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

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

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

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

Audit Evidence for Elements of the Control Environment

A79. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.

A80. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

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

A81. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

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

A82. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.

A83. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in HKSA 330, the control environment also influences the nature, timing and extent of the auditor's further procedures.[14]

A84. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Considerations Specific to Smaller Entities

A85. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small entity; it may, however, increase other risks, for example, the risk of override of controls.

A86. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.

A87. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

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

A88. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

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

A89. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

[14] HKSA 330, paragraphs A2–A3

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

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

A90. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements.

A91. Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information may include:

- Information obtained from lease agreements disclosed in the financial statements, such as renewal options or future lease payments.
- Information disclosed in the financial statements that is produced by an entity's risk management system.
- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
    - o Assumptions developed internally that may affect an asset's useful life; or
    - o Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.[15]

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[15] See paragraphs 19-20 of HKSA 570 (Revised), *Going Concern*.

A92. The understanding of the information system relevant to financial reporting required by paragraph 18 of this HKSA (including the understanding of relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers) is a matter of the auditor's professional judgment. For example, certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

Journal entries (Ref: Para. 18 (f))

A93. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A94. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes (Ref: Para. 18)

A95. An entity's business processes are the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;
- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

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

Considerations specific to smaller entities (Ref: Para. 18)

A96. The information system, and related business processes, relevant to financial reporting in small entities, including relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers, is likely to be less sophisticated than in larger entities, but its role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information system relevant to financial reporting may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

A97. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A98. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

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

A99. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

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

A100. Control activities that are relevant to the audit are:

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

A101. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A102. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A103. Control activities relevant to the audit may include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework, in addition to controls that address risks related to account balances and transactions. Such control activities may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

A104. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations Specific to Smaller Entities

A105. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A106. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks Arising from IT (Ref: Para. 21)

A107. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.

A108. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

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

They are generally implemented to deal with the risks referred to in paragraph A64 above.

A109. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

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

A110. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A111. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations Specific to Smaller Entities

A112. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

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

A113. If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this HKSA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

A114. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.

A115. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.

A116. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this HKSA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.

A117. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.

A118. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, HKSA 610 (Revised 2013) applies.

A119. As is further discussed in HKSA 610 (Revised 2013), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.

A120. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. HKSA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

Sources of Information (Ref: Para. 24)

A121. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

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

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

Identifying and Assessing the Risks of Material Misstatement

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

A122. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A123. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as a lack of management competence or lack of oversight over the preparation of the financial statements may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A124. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.

- Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

A125. HKSA 705 (Revised)[16] establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

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

A126. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A127. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding recognition, measurement and presentation of classes of transactions and events, account balances and disclosures.

A128. The auditor may use the assertions as described in paragraph A129(a)-(b)below or may express them differently provided all aspects described below have been covered. For example, the auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

Assertions about classes of transactions, account balances, and related disclosures

A129. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:

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

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

(ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

(iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

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

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

16 HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

(vi) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

(b) Assertions about account balances, and related disclosures, at the period end:

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

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

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

(iv) Accuracy, valuation and allocation—assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

(v) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.

(vi) Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about other disclosures

A130. The assertions described in paragraph A129(a)-(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of potential misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, the entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

Considerations specific to public sector entities

A131. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A129(a)-(b), management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

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

A132. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed. In identifying the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with HKSA 200.[17]

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[17] HKSA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 15

A133. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement, including risks of material misstatement relating to disclosures.

A134. As explained in HKSA 320,[18] materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial reporting needs of users of the financial statements.[19]

A135. The auditor's consideration of disclosures in the financial statements when identifying risks includes quantitative and qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole). Depending on the circumstances of the entity and the engagement, examples of disclosures that will have qualitative aspects and that may be relevant when assessing the risks of material misstatement include disclosures about:

- Liquidity and debt covenants of an entity in financial distress.
- Events or circumstances that have led to the recognition of an impairment loss.
- Key sources of estimation uncertainty, including assumptions about the future.
- The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.
- Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.
- Related parties, and related party transactions.
- Sensitivity analysis, including the effects of changes in assumptions used in the entity's valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount.

Considerations specific to smaller entities

A136. Disclosures in the financial statements of smaller entities may be less detailed or less complex (e.g., some financial reporting frameworks allow smaller entities to provide fewer disclosures in the financial statements). However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, including internal control, as it relates to disclosures.

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

A137. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

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[18] HKSA 320, paragraph A1

[19] HKSA 320, paragraph 4

A138. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

A139. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Material Misstatements

A140. Potential misstatements in individual statements and disclosures may be judged to be material due to size, nature or circumstances. (Ref: Para. 26(d))

Significant Risks

Identifying Significant Risks (Ref: Para. 28)

A141. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A142. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

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

A143. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

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

A144. HKSA 330 describes the consequences for further audit procedures of identifying a risk as significant.[20]

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[20] HKSA 330, paragraphs 15 and 21

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

A145. HKSA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.[21]

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

A146. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

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

A147. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A148. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.[22]

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

A149. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A150. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

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[21] HKSA 240, paragraphs 25–27

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

A151. The consequences for further audit procedures of identifying such risks are described in HKSA 330.[23]

Revision of Risk Assessment (Ref: Para. 31)

A152. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See HKSA 330 for further guidance.

Documentation (Ref: Para. 32)

A153. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.[24] Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.[25] The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A154. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A155. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of HKSA 230 are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A156. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

23 HKSA 330, paragraph 8
24 HKSA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9
25 HKSA 330, paragraph 28

Appendix 1

(Ref: Para. 4(c), 14–24, A77–A121)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14–24 and A77–A121, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:

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

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

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

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

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

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

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

Entity's Risk Assessment Process

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

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

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

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

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

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

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

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

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

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

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

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

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

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

   - Identify and record all valid transactions.
   - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
   - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
   - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
   - Present properly the transactions and related disclosures in the financial statements.

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

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

Control Activities

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

   - *Performance reviews*. These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
   - *Information processing*. The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

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

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

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

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

Monitoring of Controls

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

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

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

Appendix 2

(Ref: Para. A41, A133)

Conditions and Events That May Indicate Risks of Material Misstatement

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

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

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

HKSA 320
Issued June 2009; revised July 2010, January 2016, June 2017

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

Hong Kong Standard on Auditing 320

Materiality in Planning and Performing an Audit

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Certified Public Accountants
香港會計師公會

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HONG KONG STANDARD ON AUDITING 320

MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

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

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Hong Kong Standard on Auditing (HKSA) 320, *Materiality in Planning and Performing an Audit*, should be read in the context of HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to apply the concept of materiality in planning and performing an audit of financial statements. HKSA 450[1] explains how materiality is applied in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.

Materiality in the Context of an Audit

2. Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

    - Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

    - Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and

    - Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.[2] The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

3. Such a discussion, if present in the applicable financial reporting framework, provides a frame of reference to the auditor in determining materiality for the audit. If the applicable financial reporting framework does not include a discussion of the concept of materiality, the characteristics referred to in paragraph 2 provide the auditor with such a frame of reference.

4. The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

    (a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

    (b) Understand that financial statements are prepared, presented and audited to levels of materiality;

    (c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

    (d) Make reasonable economic decisions on the basis of the information in the financial statements.

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[1] HKSA 450, *Evaluation of Misstatements Identified during the Audit*

[2] For example, the *Framework for the Preparation and Presentation of Financial Statements*, revised by the Hong Kong Institute of Certified Public Accountants in May 2003, indicates that, for a profit-oriented entity, as investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

5. The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements and in forming the opinion in the auditor's report. (Ref: Para. A1)

6. In planning the audit, the auditor makes judgments about misstatements that will be considered material. These judgments provide a basis for:

   (a) Determining the nature, timing and extent of risk assessment procedures;

   (b) Identifying and assessing the risks of material misstatement; and

   (c) Determining the nature, timing and extent of further audit procedures.

   The materiality determined when planning the audit does not necessarily establish an amount below which uncorrected misstatements, individually or in the aggregate, will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. It is not practicable to design audit procedures to detect all misstatements that could be material solely because of their nature. However, consideration of the nature of potential misstatements in disclosures is relevant to the design of audit procedures to address risks of material misstatement.[3] In addition, when evaluating the effect on the financial statements of all uncorrected misstatements, the auditor considers not only the size but also the nature of uncorrected misstatements, and the particular circumstances of their occurrence.[4] (Ref: Para. A2)

Effective Date

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

Objective

8. The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

Definition

9. For purposes of the HKSAs, performance materiality means the amount or amounts 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. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

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3 See HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, paragraphs A134-A135.

4 HKSA 450, paragraph A21

Requirements

Determining Materiality and Performance Materiality When Planning the Audit

10. When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A3-A12)

11. The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A13)

Revision as the Audit Progresses

12. The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A14)

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

Documentation

14. The auditor shall include in the audit documentation the following amounts and the factors considered in their determination: [5]

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

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

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

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

Conformity and Compliance with International Standards on Auditing

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

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[5] HKSA 230, *Audit Documentation*, paragraphs 8-11, and A6

Application and Other Explanatory Material

Materiality and Audit Risk (Ref: Para. 5)

A1. In conducting an audit of financial statements, the overall objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the HKSAs, in accordance with the auditor's findings.[6] The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.[7] Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk.[8] Materiality and audit risk are considered throughout the audit, in particular, when:

(a) Identifying and assessing the risks of material misstatement;[9]

(b) Determining the nature, timing and extent of further audit procedures;[10] and

(c) Evaluating the effect of uncorrected misstatements, if any, on the financial statements[11] and in forming the opinion in the auditor's report.[12]

Materiality in the Context of an Audit (Ref: Para. 6)

A2. Identifying and assessing the risks of material misstatement[13] involves the use of professional judgment to identify those classes of transactions, account balances and disclosures, including qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole). When considering whether misstatements in qualitative disclosures could be material, the auditor may identify relevant factors such as:

- The circumstances of the entity for the period (for example, the entity may have undertaken a significant business combination during the period).

- The applicable financial reporting framework, including changes therein (for example, a new financial reporting standard may require new qualitative disclosures that are significant to the entity).

- Qualitative disclosures that are important to users of the financial statements because of the nature of an entity (for example, liquidity risk disclosures may be important to users of the financial statements for a financial institution).

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6 HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 11

7 HKSA 200, paragraph 17

8 HKSA 200, paragraph 13(c)

9 HKSA 315 (Revised)

10 HKSA 330, *The Auditor's Responses to Assessed Risks*

11 HKSA 450

12 HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

13 HKSA 315 (Revised), paragraph 25, requires the auditor to identify and assess the risk of material misstatement at the financial statement and assertion level.

Determining Materiality and Performance Materiality When Planning the Audit

Considerations Specific To Public Sector Entities (Ref: Para. 10)

A3. In the case of a public sector entity, legislators and regulators are often the primary users of its financial statements. Furthermore, the financial statements may be used to make decisions other than economic decisions. The determination of materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) in an audit of the financial statements of a public sector entity is therefore influenced by law, regulation or other authority, and by the financial information needs of legislators and the public in relation to public sector programs.

Use of Benchmarks in Determining Materiality for the Financial Statements as a Whole (Ref: Para. 10)

A4. Determining materiality involves the exercise of professional judgment. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole. Factors that may affect the identification of an appropriate benchmark include the following:

- The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses);
- Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused (for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue or net assets);
- The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates;
- The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings); and
- The relative volatility of the benchmark.

A5. Examples of benchmarks that may be appropriate, depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value. Profit before tax from continuing operations is often used for profit-oriented entities. When profit before tax from continuing operations is volatile, other benchmarks may be more appropriate, such as gross profit or total revenues.

A6. In relation to the chosen benchmark, relevant financial data ordinarily includes prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, adjusted for significant changes in the circumstances of the entity (for example, a significant business acquisition) and relevant changes of conditions in the industry or economic environment in which the entity operates. For example, when, as a starting point, materiality for the financial statements as a whole is determined for a particular entity based on a percentage of profit before tax from continuing operations, circumstances that give rise to an exceptional decrease or increase in such profit may lead the auditor to conclude that materiality for the financial statements as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results.

A7. Materiality relates to the financial statements on which the auditor is reporting. Where the financial statements are prepared for a financial reporting period of more or less than twelve months, such as may be the case for a new entity or a change in the financial reporting period, materiality relates to the financial statements prepared for that financial reporting period.

A8. Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. There is a relationship between the percentage and the chosen benchmark, such that a percentage applied to profit before tax from continuing operations will normally be higher than a percentage applied to total revenue. For example, the auditor may consider five percent of profit before tax from continuing operations to be appropriate for a profit-oriented entity in a manufacturing industry, while the auditor may consider one percent of total revenue or total expenses to be appropriate for a not-for-profit entity. Higher or lower percentages, however, may be deemed appropriate in the circumstances.

Considerations Specific to Small Entities

A9. When an entity's profit before tax from continuing operations is consistently nominal, as might be the case for an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

Considerations Specific to Public Sector Entities

A10. In an audit of a public sector entity, total cost or net cost (expenses less revenues or expenditure less receipts) may be appropriate benchmarks for program activities. Where a public sector entity has custody of public assets, assets may be an appropriate benchmark.

Materiality Level or Levels for Particular Classes of Transactions, Account Balances or Disclosures (Ref: Para. 10)

A11. Factors that may indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements include the following:

- Whether law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related party transactions, the remuneration of management and those charged with governance, and sensitivity analysis for fair value accounting estimates with high estimation uncertainty).

- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).

- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, disclosures about segments or a significant business combination).

A12. In considering whether, in the specific circumstances of the entity, such classes of transactions, account balances or disclosures exist, the auditor may find it useful to obtain an understanding of the views and expectations of those charged with governance and management.

Performance Materiality (Ref: Para. 11)

A13. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Revision as the Audit Progresses (Ref: Para. 12)

A14. Materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) may need to be revised as a result of a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business), new information, or a change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures. For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

HKSA 330
Issued June 2009; revised July 2010, December 2012,
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Effective for audits of financial statements
for periods beginning on or after 15 December 2009

Hong Kong Standard on Auditing 330

The Auditor's Responses to Assessed Risks

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

HONG KONG STANDARD ON AUDITING 330

THE AUDITOR’S RESPONSES TO ASSESSED RISKS

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

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Hong Kong Standard on Auditing (HKSA) 330, *The Auditor’s Responses to Assessed Risks*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

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

Effective Date

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

Objective

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

Definitions

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

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

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

      (ii) Substantive analytical procedures.

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

Requirements

Overall Responses

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

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

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

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

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

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

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

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

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

Tests of Controls

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

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

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

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

Nature and Extent of Tests of Controls

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

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

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

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

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

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

Timing of Tests of Controls

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

Using audit evidence obtained during an interim period

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

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

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

Using audit evidence obtained in previous audits

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

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

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

    (c) The effectiveness of general IT controls;

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

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

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

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

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

(b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37-39)

Controls over significant risks

15. If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

Evaluating the Operating Effectiveness of Controls

16. When evaluating the operating effectiveness of relevant controls, the auditor shall evaluate whether misstatements that have been detected by substantive procedures indicate that controls are not operating effectively. The absence of misstatements detected by substantive procedures, however, does not provide audit evidence that controls related to the assertion being tested are effective. (Ref: Para. A40)

17. If deviations from controls upon which the auditor intends to rely are detected, the auditor shall make specific inquiries to understand these matters and their potential consequences, and shall determine whether: (Ref: Para. A41)

(a) The tests of controls that have been performed provide an appropriate basis for reliance on the controls;

(b) Additional tests of controls are necessary; or

(c) The potential risks of misstatement need to be addressed using substantive procedures.

Substantive Procedures

18. Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42-A47)

19. The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48-A51)

Substantive Procedures Related to the Financial Statement Closing Process

20. The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

(a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and

(b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)

Substantive Procedures Responsive to Significant Risks

21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically

responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

Timing of Substantive Procedures

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

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

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

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

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

Adequacy of Presentation of the Financial Statements

24. The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework. In making this evaluation, the auditor shall consider whether the financial statements are presented in a manner that reflects the appropriate:

    - Classification and description of financial information and the underlying transactions, events and conditions; and

    - Presentation, structure and content of the financial statements. (Ref: Para. A59)

Evaluating the Sufficiency and Appropriateness of Audit Evidence

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

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

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

Documentation

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

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

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

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

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

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

30. The auditor's documentation shall demonstrate that information in the financial statements agrees or reconciles with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers.

Conformity and Compliance with International Standards on Auditing

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

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Application and Other Explanatory Material

Overall Responses (Ref: Para. 5)

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

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

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

- Conducting more audit procedures as of the period end rather than at an interim date.

- Obtaining more extensive audit evidence from substantive procedures.

- Increasing the number of locations to be included in the audit scope.

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

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

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

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

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

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

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

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

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

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

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

A8. Designing and performing further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level provides a clear linkage between the auditor's further audit procedures and the risk assessment.

Responding to the Assessed Risks at the Assertion Level (Ref: Para. 7(a))

Nature

A9. The auditor's assessed risks may affect both the types of audit procedures to be performed and their combination. For example, when an assessed risk is high, the auditor may confirm the completeness of the terms of a contract with the counterparty, in addition to inspecting the document. Further, certain audit procedures may be more appropriate for some assertions than others. For example, in relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.

A10. The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a). This may be the case, for example, for a class of transactions of reasonably uniform, non-complex characteristics that are routinely processed and controlled by the entity's information system.

Timing

A11. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). This is particularly relevant when considering the response to the risks of fraud. For example, the auditor may conclude that, when the risks of intentional misstatement or manipulation have been identified, audit procedures to extend audit conclusions from interim date to the period end would not be effective.

A12. On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

A13. In addition, certain audit procedures can be performed only at or after the period end, for example:

- Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling disclosures, whether such information is obtained from within or outside of the general subsidiary ledgers;
- Examining adjustments made during the course of preparing the financial statements; and
- Procedures to respond to a risk that, at the period end, the entity may have entered into improper sales contracts, or transactions may not have been finalized.

A14. Further relevant factors that influence the auditor's consideration of when to perform audit procedures include the following:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.
- The timing of the preparation of the financial statements, particularly for those disclosures that provide further explanation about amounts recorded in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

Extent

A15. The extent of an audit procedure judged necessary is determined after considering the materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. When a single purpose is met by a combination of procedures, the extent of each procedure is considered separately. In general, the extent of audit procedures increases as the risk of material misstatement increases. For example, in response to the assessed risk of material misstatement due to fraud, increasing sample sizes or performing substantive analytical procedures at a more detailed level may be appropriate. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk.

A16. The use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files, which may be useful when the auditor decides to modify the extent of testing, for example, in responding to the risks of material misstatement due to fraud. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.

Considerations specific to public sector entities

A17. For the audits of public sector entities, the audit mandate and any other special auditing requirements may affect the auditor's consideration of the nature, timing and extent of further audit procedures.

Considerations specific to smaller entities

A18. In the case of very small entities, there may not be many control activities that could be identified by the auditor, or the extent to which their existence or operation have been documented by the entity may be limited. In such cases, it may be more efficient for the auditor to perform further audit procedures that are primarily substantive procedures. In some rare cases, however, the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence.

Higher Assessments of Risk (Ref: Para. 7(b))

A19. When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.

Tests of Controls

Designing and Performing Tests of Controls (Ref: Para. 8)

A20. Tests of controls are performed only on those controls that the auditor has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. If substantially different controls were used at different times during the period under audit, each is considered separately.

A21. Testing the operating effectiveness of controls is different from obtaining an understanding of and evaluating the design and implementation of controls. However, the same types of audit procedures are used. The auditor may, therefore, decide it is efficient to test the operating effectiveness of controls at the same time as evaluating their design and determining that they have been implemented.

A22. Further, although some risk assessment procedures may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, the auditor's risk assessment procedures may have included:

- Inquiring about management's use of budgets.
- Observing management's comparison of monthly budgeted and actual expenses.
- Inspecting reports pertaining to the investigation of variances between budgeted and actual amounts.

These audit procedures provide knowledge about the design of the entity's budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

A23. In addition, the auditor may design a test of controls to be performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from the purpose of a test of details, both may be accomplished concurrently by performing a test of controls and a test of details on the same transaction, also known as a dual-purpose test. For example, the auditor may design, and evaluate the results of, a test to examine an invoice to determine whether it has been approved and to provide substantive audit evidence of a transaction. A dual-purpose test is designed and evaluated by considering each purpose of the test separately.

A24. In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.[3] This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls.

[3] HKSA 315 (Revised), paragraph 30

Audit Evidence and Intended Reliance (Ref: Para. 9)

A25. A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Nature and Extent of Tests of Controls

Other audit procedures in combination with inquiry (Ref: Para. 10(a))

A26. Inquiry alone is not sufficient to test the operating effectiveness of controls. Accordingly, other audit procedures are performed in combination with inquiry. In this regard, inquiry combined with inspection or reperformance may provide more assurance than inquiry and observation, since an observation is pertinent only at the point in time at which it is made.

A27. The nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect it to obtain audit evidence about operating effectiveness. For other controls, however, documentation may not be available or relevant. For example, documentation of operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed by a computer. In such circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation or the use of CAATs.

Extent of tests of controls

A28. When more persuasive audit evidence is needed regarding the effectiveness of a control, it may be appropriate to increase the extent of testing of the control. As well as the degree of reliance on controls, matters the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The expected rate of deviation from a control.
- The relevance and reliability of the audit evidence to be obtained regarding the operating effectiveness of the control at the assertion level.
- The extent to which audit evidence is obtained from tests of other controls related to the assertion.

HKSA 530[4] contains further guidance on the extent of testing.

[4] HKSA 530, *Audit Sampling*

A29. Because of the inherent consistency of IT processing, it may not be necessary to increase the extent of testing of an automated control. An automated control can be expected to function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once the auditor determines that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), the auditor may consider performing tests to determine that the control continues to function effectively. Such tests might include determining that:

- Changes to the program are not made without being subject to the appropriate program change controls;
- The authorized version of the program is used for processing transactions; and
- Other relevant general controls are effective.

Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorized access has not occurred during the period.

Testing of indirect controls (Ref: Para. 10(b))

A30. In some circumstances, it may be necessary to obtain audit evidence supporting the effective operation of indirect controls. For example, when the auditor decides to test the effectiveness of a user review of exception reports detailing sales in excess of authorized credit limits, the user review and related follow up is the control that is directly of relevance to the auditor. Controls over the accuracy of the information in the reports (for example, the general IT controls) are described as "indirect" controls.

A31. Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated application control, when considered in combination with audit evidence about the operating effectiveness of the entity's general controls (in particular, change controls), may also provide substantial audit evidence about its operating effectiveness.

Timing of Tests of Controls

Intended period of reliance (Ref: Para. 11)

A32. Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the entity's physical inventory counting at the period end. If, on the other hand, the auditor intends to rely on a control over a period, tests that are capable of providing audit evidence that the control operated effectively at relevant times during that period are appropriate. Such tests may include tests of the entity's monitoring of controls.

Using audit evidence obtained during an interim period (Ref: Para. 12(b))

A33. Relevant factors in determining what additional audit evidence to obtain about controls that were operating during the period remaining after an interim period, include:

- The significance of the assessed risks of material misstatement at the assertion level.
- The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes, and personnel.

- The degree to which audit evidence about the operating effectiveness of those controls was obtained.

- The length of the remaining period.

- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls.

- The control environment.

A34. Additional audit evidence may be obtained, for example, by extending tests of controls over the remaining period or testing the entity's monitoring of controls.

Using audit evidence obtained in previous audits (Ref: Para. 13)

A35. In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor performs audit procedures to establish its continuing relevance. For example, in performing a previous audit, the auditor may have determined that an automated control was functioning as intended. The auditor may obtain audit evidence to determine whether changes to the automated control have been made that affect its continued effective functioning through, for example, inquiries of management and the inspection of logs to indicate what controls have been changed. Consideration of audit evidence about these changes may support either increasing or decreasing the expected audit evidence to be obtained in the current period about the operating effectiveness of the controls.

Controls that have changed from previous audits (Ref: Para. 14(a))

A36. Changes may affect the relevance of the audit evidence obtained in previous audits such that there may no longer be a basis for continued reliance. For example, changes in a system that enable an entity to receive a new report from the system probably do not affect the relevance of audit evidence from a previous audit; however, a change that causes data to be accumulated or calculated differently does affect it.

Controls that have not changed from previous audits (Ref: Para. 14(b))

A37. The auditor's decision on whether to rely on audit evidence obtained in previous audits for controls that:

(a) have not changed since they were last tested; and

(b) are not controls that mitigate a significant risk,

is a matter of professional judgment. In addition, the length of time between retesting such controls is also a matter of professional judgment, but is required by paragraph 14 (b) to be at least once in every third year.

A38. In general, the higher the risk of material misstatement, or the greater the reliance on controls, the shorter the time period elapsed, if any, is likely to be. Factors that may decrease the period for retesting a control, or result in not relying on audit evidence obtained in previous audits at all, include the following:

- A deficient control environment.

- Deficient monitoring of controls.

- A significant manual element to the relevant controls.
- Personnel changes that significantly affect the application of the control.
- Changing circumstances that indicate the need for changes in the control.
- Deficient general IT controls.

A39. When there are a number of controls for which the auditor intends to rely on audit evidence obtained in previous audits, testing some of those controls in each audit provides corroborating information about the continuing effectiveness of the control environment. This contributes to the auditor's decision about whether it is appropriate to rely on audit evidence obtained in previous audits.

Evaluating the Operating Effectiveness of Controls (Ref: Para. 16-17)

A40. A material misstatement detected by the auditor's procedures is a strong indicator of the existence of a significant deficiency in internal control.

A41. The concept of effectiveness of the operation of controls recognizes that some deviations in the way controls are applied by the entity may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions and human error. The detected rate of deviation, in particular in comparison with the expected rate, may indicate that the control cannot be relied on to reduce risk at the assertion level to that assessed by the auditor.

Substantive Procedures (Ref: Para. 18)

A42. Paragraph 18 requires the auditor to design and perform substantive procedures for each material class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. This requirement reflects the facts that: (a) the auditor's assessment of risk is judgmental and so may not identify all risks of material misstatement; and (b) there are inherent limitations to internal control, including management override.

Nature and Extent of Substantive Procedures

A43. Depending on the circumstances, the auditor may determine that:

- Performing only substantive analytical procedures will be sufficient to reduce audit risk to an acceptably low level. For example, where the auditor's assessment of risk is supported by audit evidence from tests of controls.
- Only tests of details are appropriate.
- A combination of substantive analytical procedures and tests of details are most responsive to the assessed risks.

A44. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. HKSA 520[5] establishes requirements and provides guidance on the application of analytical procedures during an audit.

5 HKSA 520, *Analytical Procedures*

A45. The nature of the risk and assertion is relevant to the design of tests of details. For example, tests of details related to the existence or occurrence assertion may involve selecting from items contained in a financial statement amount and obtaining the relevant audit evidence. On the other hand, tests of details related to the completeness assertion may involve selecting from items that are expected to be included in the relevant financial statement amount and investigating whether they are included.

A46. Because the assessment of the risk of material misstatement takes account of internal control, the extent of substantive procedures may need to be increased when the results from tests of controls are unsatisfactory. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

A47. In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size. However, other matters are also relevant, including whether it is more effective to use other selective means of testing. See HKSA 500. [6]

Considering Whether External Confirmation Procedures Are to Be Performed (Ref: Para. 19)

A48. External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. For example, the auditor may request external confirmation of the terms of agreements, contracts, or transactions between an entity and other parties. External confirmation procedures also may be performed to obtain audit evidence about the absence of certain conditions. For example, a request may specifically seek confirmation that no "side agreement" exists that may be relevant to an entity's revenue cutoff assertion. Other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement include:

- Bank balances and other information relevant to banking relationships.
- Accounts receivable balances and terms.
- Inventories held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments held for safekeeping by third parties, or purchased from stockbrokers but not delivered at the balance sheet date.
- Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
- Accounts payable balances and terms.

A49. Although external confirmations may provide relevant audit evidence relating to certain assertions, there are some assertions for which external confirmations provide less relevant audit evidence. For example, external confirmations provide less relevant audit evidence relating to the recoverability of accounts receivable balances, than they do of their existence.

6 HKSA 500, *Audit Evidence*, paragraph 10

A50. The auditor may determine that external confirmation procedures performed for one purpose provide an opportunity to obtain audit evidence about other matters. For example, confirmation requests for bank balances often include requests for information relevant to other financial statement assertions. Such considerations may influence the auditor's decision about whether to perform external confirmation procedures.

A51. Factors that may assist the auditor in determining whether external confirmation procedures are to be performed as substantive audit procedures include:

- The confirming party's knowledge of the subject matter – responses may be more reliable if provided by a person at the confirming party who has the requisite knowledge about the information being confirmed.
- The ability or willingness of the intended confirming party to respond – for example, the confirming party:
  - May not accept responsibility for responding to a confirmation request;
  - May consider responding too costly or time consuming;
  - May have concerns about the potential legal liability resulting from responding;
  - May account for transactions in different currencies; or
  - May operate in an environment where responding to confirmation requests is not a significant aspect of day-to-day operations.

  In such situations, confirming parties may not respond, may respond in a casual manner or may attempt to restrict the reliance placed on the response.
- The objectivity of the intended confirming party – if the confirming party is a related party of the entity, responses to confirmation requests may be less reliable.

Substantive Procedures Related to the Financial Statement Closing Process (Ref: Para. 20)

A52. The nature, and also the extent, of the auditor's substantive procedures related to the financial statement closing process depends on the nature and complexity of the entity's financial reporting process and the related risks of material misstatement.

Substantive Procedures Responsive to Significant Risks (Ref: Para. 21)

A53. Paragraph 21 of this HKSA requires the auditor to perform substantive procedures that are specifically responsive to risks the auditor has determined to be significant risks. Audit evidence in the form of external confirmations received directly by the auditor from appropriate confirming parties may assist the auditor in obtaining audit evidence with the high level of reliability that the auditor requires to respond to significant risks of material misstatement, whether due to fraud or error. For example, if the auditor identifies that management is under pressure to meet earnings expectations, there may be a risk that management is inflating sales by improperly recognizing revenue related to sales agreements with terms that preclude revenue recognition or by invoicing sales before shipment. In these circumstances, the auditor may, for example, design external confirmation procedures not only to confirm outstanding amounts, but also to confirm the details of the sales agreements, including date, any rights of return and delivery terms. In addition, the auditor may find it effective to supplement such external confirmation procedures with inquiries of non-financial personnel in the entity regarding any changes in sales agreements and delivery terms.

Timing of Substantive Procedures (Ref: Para. 22-23)

A54. In most cases, audit evidence from a previous audit's substantive procedures provides little or no audit evidence for the current period. There are, however, exceptions, for example, a legal opinion obtained in a previous audit related to the structure of a securitization to which no changes have occurred, may be relevant in the current period. In such cases, it may be appropriate to use audit evidence from a previous audit's substantive procedures if that evidence and the related subject matter have not fundamentally changed, and audit procedures have been performed during the current period to establish its continuing relevance.

Using audit evidence obtained during an interim period (Ref: Para. 22)

A55. In some circumstances, the auditor may determine that it is effective to perform substantive procedures at an interim date, and to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date to:

(a) Identify amounts that appear unusual;

(b) Investigate any such amounts; and

(c) Perform substantive analytical procedures or tests of details to test the intervening period.

A56. Performing substantive procedures at an interim date without undertaking additional procedures at a later date increases the risk that the auditor will not detect misstatements that may exist at the period end. This risk increases as the remaining period is lengthened. Factors such as the following may influence whether to perform substantive procedures at an interim date:

- The control environment and other relevant controls.
- The availability at a later date of information necessary for the auditor's procedures.
- The purpose of the substantive procedure.
- The assessed risk of material misstatement.
- The nature of the class of transactions or account balance and related assertions.
- The ability of the auditor to perform appropriate substantive procedures or substantive procedures combined with tests of controls to cover the remaining period in order to reduce the risk that misstatements that may exist at the period end will not be detected.

A57. Factors such as the following may influence whether to perform substantive analytical procedures with respect to the period between the interim date and the period end:

- Whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.
- Whether the entity's procedures for analyzing and adjusting such classes of transactions or account balances at interim dates and for establishing proper accounting cutoffs are appropriate.

- Whether the information system relevant to financial reporting will provide information concerning the balances at the period end and the transactions in the remaining period that is sufficient to permit investigation of:

    (a) Significant unusual transactions or entries (including those at or near the period end);

    (b) Other causes of significant fluctuations, or expected fluctuations that did not occur; and

    (c) Changes in the composition of the classes of transactions or account balances.

Misstatements detected at an interim date (Ref: Para. 23)

A58. When the auditor concludes that the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified as a result of unexpected misstatements detected at an interim date, such modification may include extending or repeating the procedures performed at the interim date at the period end.

Adequacy of Presentation of the Financial Statements (Ref: Para. 24)

A59. Evaluating the appropriate presentation, arrangement and content of the financial statements, includes, for example, consideration of the terminology used as required by the applicable financial reporting framework, the level of detail provided, the aggregation and disaggregation of amounts and the bases of amounts set forth.

Evaluating the Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 25-27)

A60. An audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. Information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example:

- The extent of misstatements that the auditor detects by performing substantive procedures may alter the auditor's judgment about the risk assessments and may indicate a significant deficiency in internal control.

- The auditor may become aware of discrepancies in accounting records, or conflicting or missing evidence.

- Analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement.

In such circumstances, the auditor may need to reevaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions. HKSA 315 (Revised) contains further guidance on revising the auditor's risk assessment. [7]

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7 HKSA 315 (Revised), paragraph 31

A61. The auditor cannot assume that an instance of fraud or error is an isolated occurrence. Therefore, the consideration of how the detection of a misstatement affects the assessed risks of material misstatement is important in determining whether the assessment remains appropriate.

A62. The auditor's judgment as to what constitutes sufficient appropriate audit evidence is influenced by such factors as the following:

- Significance of the potential misstatement in the assertion and the likelihood of its having a material effect, individually or aggregated with other potential misstatements, on the financial statements.
- Effectiveness of management's responses and controls to address the risks.
- Experience gained during previous audits with respect to similar potential misstatements.
- Results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error.
- Source and reliability of the available information.
- Persuasiveness of the audit evidence.
- Understanding of the entity and its environment, including the entity's internal control.

Documentation (Ref: Para. 28)

A63. The form and extent of audit documentation is a matter of professional judgment, and is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the audit.

HKSA 450

Issued July 2009; revised July 2010, August 2015, January 2016, June 2017

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

Hong Kong Standard on Auditing 450

Evaluation of Misstatements Identified during the Audit

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

HONG KONG STANDARD ON AUDITING 450

EVALUATION OF MISSTATEMENTS IDENTIFIED DURING THE AUDIT

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

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Hong Kong Standard on Auditing (HKSA) 450, *Evaluation of Misstatements Identified during the Audit*, should be read in the context of HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements. HKSA 700 (Revised) deals with the auditor's responsibility, in forming an opinion on the financial statements, to conclude whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement. The auditor's conclusion required by HKSA 700 (Revised) takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements, in accordance with this HKSA.[1] HKSA 320[2] deals with the auditor's responsibility to apply the concept of materiality appropriately in planning and performing an audit of financial statements.

Effective Date

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

Objective

3. The objective of the auditor is to evaluate:

   (a) The effect of identified misstatements on the audit; and

   (b) The effect of uncorrected misstatements, if any, on the financial statements.

Definitions

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

   (a) Misstatement – A difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. (Ref: Para. A1)

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

   (b) Uncorrected misstatements – Misstatements that the auditor has accumulated during the audit and that have not been corrected.

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1 HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 10-11

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

Requirements

Accumulation of Identified Misstatements

5. The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A6)

Consideration of Identified Misstatements as the Audit Progresses

6. The auditor shall determine whether the overall audit strategy and audit plan need to be revised if:

   (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A7)

   (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with HKSA 320. (Ref: Para. A8)

7. If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A9)

Communication and Correction of Misstatements

8. The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation.[3] The auditor shall request management to correct those misstatements. (Ref: Para. A10-A12)

9. If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A13)

Evaluating the Effect of Uncorrected Misstatements

10. Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with HKSA 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A14-A15)

11. The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider:

   (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A16-A22, A24-A25)

   (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A23)

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[3] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 7

Communication with Those Charged with Governance

12. The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation.[4] The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A26-A28)

13. The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Written Representations

14. The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A29)

Documentation

15. The auditor shall include in the audit documentation: [5] (Ref: Para. A30)

    (a) The amount below which misstatements would be regarded as clearly trivial (paragraph 5);

    (b) All misstatements accumulated during the audit and whether they have been corrected (paragraphs 5, 8 and 12); and

    (c) The auditor's conclusion as to whether uncorrected misstatements are material, individually or in aggregate, and the basis for that conclusion (paragraph 11).

Conformity and Compliance with International Standards on Auditing

16. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 450, *Evaluation of Misstatements Identified during the Audit*. Compliance with the requirements of this HKSA ensures compliance with ISA 450.

***

Application and Other Explanatory Material

Definition of Misstatement (Ref: Para. 4(a))

A1. Misstatements may result from:

    (a) An inaccuracy in gathering or processing data from which the financial statements are prepared;

    (b) An omission of an amount or disclosure, including inadequate or incomplete disclosures, and those disclosures required to meet disclosure objectives of certain financial reporting frameworks as applicable;[6]

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4 See footnote 3.

5 HKSA 230, *Audit Documentation*, paragraphs 8-11, and A6

6 For example, Hong Kong Financial Reporting Standard 7 (HKFRS), *Financial Instruments: Disclosures*, paragraph 42H states that "an entity shall disclose any additional information that it considers necessary to meet the disclosure objectives in paragraph …"

(c) An incorrect accounting estimate arising from overlooking, or clear misinterpretation of, facts;

(d) Judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection and application of accounting policies that the auditor considers inappropriate.

(e) An inappropriate classification, aggregation or disaggregation, of information; and

(f) For financial statements prepared in accordance with a fair presentation framework, the omission of a disclosure necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by the framework.[7]

Examples of misstatements arising from fraud are provided in HKSA 240.[8]

Accumulation of Identified Misstatements (Ref: Para. 5)

"Clearly Trivial"

A2. Paragraph 5 of this HKSA requires the auditor to accumulate misstatements identified during the audit other than those that are clearly trivial. "Clearly trivial" is not another expression for "not material." Misstatements that are clearly trivial will be of a wholly different (smaller) order of magnitude, or of a wholly different nature than those that would be determined to be material, and will be misstatements that are clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items are clearly trivial, the misstatement is considered not to be clearly trivial.

Misstatements in Individual Statements

A3. The auditor may designate an amount below which misstatements of amounts in the individual statements would be clearly trivial, and would not need to be accumulated because the auditor expects that the accumulation of such amounts clearly would not have a material effect on the financial statements. However, misstatements of amounts that are above the designated amount are accumulated as required by paragraph 5 of this HKSA. In addition, misstatements relating to amounts may not be clearly trivial when judged on criteria of nature or circumstances, and, if not, are accumulated as required by paragraph 5 of this HKSA.

Misstatements in Disclosures

A4. Misstatements in disclosures may also be clearly trivial whether taken individually or in aggregate, and whether judged by any criteria of size, nature or circumstances. Misstatements in disclosures that are not clearly trivial are also accumulated to assist the auditor in evaluating the effect of such misstatements on the relevant disclosures and the financial statements as a whole. Paragraph A17 of this HKSA provides examples of where misstatements in qualitative disclosures may be material.

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7 For example, HKFRS requires an entity to provide additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (Hong Kong Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

8 HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs A1-A6

Accumulation of Misstatements

A5. Misstatements by nature or circumstances, accumulated as described in paragraphs A3-A4, cannot be added together as is possible in the case of misstatements of amounts. Nevertheless, the auditor is required by paragraph 11 of this HKSA to evaluate those misstatements individually and in aggregate (i.e., collectively with other misstatements) to determine whether they are material.

A6. To assist the auditor in evaluating the effect of misstatements accumulated during the audit and in communicating misstatements to management and those charged with governance, it may be useful to distinguish between factual misstatements, judgmental misstatements and projected misstatements.

- Factual misstatements are misstatements about which there is no doubt.
- Judgmental misstatements are differences arising from the judgments of management including those concerning recognition, measurement, presentation and disclosure in the financial statements (including the selection or application of accounting policies) that the auditor considers unreasonable or inappropriate.
- Projected misstatements are the auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn. Guidance on the determination of projected misstatements and evaluation of the results is set out in HKSA 530.[9]

Consideration of Identified Misstatements as the Audit Progresses (Ref: Para. 6-7)

A7. A misstatement may not be an isolated occurrence. Evidence that other misstatements may exist include, for example, where the auditor identifies that a misstatement arose from a breakdown in internal control or from inappropriate assumptions or valuation methods that have been widely applied by the entity.

A8. If the aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with HKSA 320, there may be a greater than acceptably low level of risk that possible undetected misstatements, when taken with the aggregate of misstatements accumulated during the audit, could exceed materiality. Undetected misstatements could exist because of the presence of sampling risk and non-sampling risk.[10]

A9. The auditor may request management to examine a class of transactions, account balance or disclosure in order for management to understand the cause of a misstatement identified by the auditor, perform procedures to determine the amount of the actual misstatement in the class of transactions, account balance or disclosure, and to make appropriate adjustments to the financial statements. Such a request may be made, for example, based on the auditor's projection of misstatements identified in an audit sample to the entire population from which it was drawn.

Communication and Correction of Misstatements (Ref: Para. 8-9)

A10. Timely communication of misstatements to the appropriate level of management is important as it enables management to evaluate whether the classes of transactions, account balances and disclosures are misstated, inform the auditor if it disagrees, and take action as necessary. Ordinarily, the appropriate level of management is the one that has responsibility and authority to evaluate the misstatements and to take the necessary action.

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9 HKSA 530, *Audit Sampling*, paragraphs 14-15

10 HKSA 530, paragraph 5(c)-(d)

A11. Law or regulation may restrict the auditor's communication of certain misstatements to management, or others, within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual, or suspected, illegal act. In some circumstances, potential conflicts between the auditor's obligations of confidentiality and obligations to communicate may be complex. In such cases, the auditor may consider seeking legal advice.

A12. The correction by management of all misstatements, including those communicated by the auditor, enables management to maintain accurate accounting books and records and reduces the risks of material misstatement of future financial statements because of the cumulative effect of immaterial uncorrected misstatements related to prior periods.

A13. HKSA 700 (Revised) requires the auditor to evaluate whether the financial statements are prepared and presented, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation includes consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments,[11] which may be affected by the auditor's understanding of management's reasons for not making the corrections.

Evaluating the Effect of Uncorrected Misstatements (Ref: Para. 10-11)

A14. The auditor's determination of materiality in accordance with HKSA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with HKSA 320 based on the actual financial results.

A15. HKSA 320 explains that, as the audit progresses, materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.[12] Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined in accordance with HKSA 320 (see paragraph 10 of this HKSA) gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

A16. Each individual misstatement of an amount is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.

A17. In addition, each individual misstatement of a qualitative disclosure is considered to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole. The determination of whether a misstatement(s) in a qualitative disclosure is material, in the context of the applicable financial reporting framework and the specific circumstances of the entity, is a matter that involves the exercise of professional judgment. Examples where such misstatements may be material include:

[11] HKSA 700 (Revised), paragraph 12

[12] HKSA 320, paragraph 12

- Inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities.

- The omission of information about the events or circumstances that have led to an impairment loss (e.g., a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations.

- The incorrect description of an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows.

- The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities.

A18. In determining whether uncorrected misstatements by nature are material as required by paragraph 11 of this HKSA, the auditor considers uncorrected misstatements in amounts and disclosures. Such misstatements may be considered material either individually, or when taken in combination with other misstatements. For example, depending on the misstatements identified in disclosures, the auditor may consider whether:

(a) Identified errors are persistent or pervasive; or

(b) A number of identified misstatements are relevant to the same matter, and considered collectively may affect the users' understanding of that matter.

This consideration of accumulated misstatements is also helpful when evaluating the financial statements in accordance with paragraph 13(d) of HKSA 700 (Revised), which requires the auditor to consider whether the overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed.

A19. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.[13]

A20. Determining whether a classification misstatement is material involves the evaluation of qualitative considerations, such as the effect of the classification misstatement on debt or other contractual covenants, the effect on individual line items or sub-totals, or the effect on key ratios. There may be circumstances where the auditor concludes that a classification misstatement is not material in the context of the financial statements as a whole, even though it may exceed the materiality level or levels applied in evaluating other misstatements. For example, a misclassification between balance sheet line items may not be considered material in the context of the financial statements as a whole when the amount of the misclassification is small in relation to the size of the related balance sheet line items and the misclassification does not affect the income statement or any key ratios.

[13] The identification of a number of immaterial misstatements within the same account balance or class of transactions may require the auditor to reassess the risk of material misstatement for that account balance or class of transactions.

A21. The circumstances related to some misstatements may cause the auditor to evaluate them as material, individually or when considered together with other misstatements accumulated during the audit, even if they are lower than materiality for the financial statements as a whole. Circumstances that may affect the evaluation include the extent to which the misstatement:

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Affects segment information presented in the financial statements (for example, the significance of the matter to a segment or other portion of the entity's business that has been identified as playing a significant role in the entity's operations or profitability);
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity; or
- Affects other information to be included in the entity's annual report (for example, information to be included in a "Management Discussion and Analysis" or an "Operating and Financial Review") that may reasonably be expected to influence the economic decisions of the users of the financial statements. HKSA 720 (Revised)[14] deals with the auditor's responsibilities relating to other information.

These circumstances are only examples; not all are likely to be present in all audits nor is the list necessarily complete. The existence of any circumstances such as these does not necessarily lead to a conclusion that the misstatement is material.

A22. HKSA 240[15] explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements. Depending on the circumstances, misstatements in disclosures could also be indicative of fraud, and, for example, may arise from:

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[14] HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

[15] HKSA 240, paragraph 35

- Misleading disclosures that have resulted from bias in management's judgments; or

- Extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements.

When considering the implications of misstatements in classes of transactions, account balances and disclosures, the auditor exercises professional skepticism in accordance with HKSA 200.[16]

A23. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

Considerations Specific to Public Sector Entities

A24. In the case of an audit of a public sector entity, the evaluation whether a misstatement is material may also be affected by the auditor's responsibilities established by law, regulation or other authority to report specific matters, including, for example, fraud.

A25. Furthermore, issues such as public interest, accountability, probity and ensuring effective legislative oversight, in particular, may affect the assessment whether an item is material by virtue of its nature. This is particularly so for items that relate to compliance with law, regulation or other authority.

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

A26. If uncorrected misstatements have been communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, they need not be communicated again with those same person(s) in their governance role. The auditor nonetheless has to be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.[17]

A27. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

A28. HKSA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see paragraph 14 of this HKSA).[18] The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

[16] HKSA 200, paragraph 15

[17] HKSA 260 (Revised), paragraph 13

[18] HKSA 260 (Revised), paragraph 16(c)(ii)

Written Representations (Ref: Para. 14)

A29. Because the preparation of the financial statements requires management and, where appropriate, those charged with governance to adjust the financial statements to correct material misstatements, the auditor is required to request them to provide a written representation about uncorrected misstatements. In some circumstances, management and, where appropriate, those charged with governance may not believe that certain uncorrected misstatements are misstatements. For that reason, they may want to add to their written representation words such as: "We do not agree that items … and … constitute misstatements because [description of reasons]." Obtaining this representation does not, however, relieve the auditor of the need to form a conclusion on the effect of uncorrected misstatements.

Documentation (Ref: Para. 15)

A30. The auditor's documentation of uncorrected misstatements may take into account:

(a) The consideration of the aggregate effect of uncorrected misstatements;

(b) The evaluation of whether the materiality level or levels for particular classes of transactions, account balances or disclosures, if any, have been exceeded; and

(c) The evaluation of the effect of uncorrected misstatements on key ratios or trends, and compliance with legal, regulatory and contractual requirements (for example, debt covenants).

HKSA 500

Issued July 2009; revised July 2010, May 2013, February 2015, August 2015, June 2017

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

Hong Kong Standard on Auditing 500

Audit Evidence

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

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HONG KONG STANDARD ON AUDITING 500

AUDIT EVIDENCE

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

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Hong Kong Standard on Auditing (HKSA) 500, *Audit Evidence*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

2. This HKSA is applicable to all the audit evidence obtained during the course of the audit. Other HKSAs deal with specific aspects of the audit (for example, HKSA 315 (Revised)[1]), the audit evidence to be obtained in relation to a particular topic (for example, HKSA 570 (Revised)[2]), specific procedures to obtain audit evidence (for example, HKSA 520[3]), and the evaluation of whether sufficient appropriate audit evidence has been obtained (HKSA 200[4] and HKSA 330[5]).

Effective Date

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

Objective

4. The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Definitions

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

   (a) Accounting records – The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

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

   (c) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and information obtained from other sources.

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

[2] HKSA 570 (Revised), *Going Concern*

[3] HKSA 520, *Analytical Procedures*.

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

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

(d) Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

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

Requirements

Sufficient Appropriate Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)

8. If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: (Ref: Para. A34-A36)

   (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)

   (b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)

   (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances:

   (a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)

   (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

Selecting Items for Testing to Obtain Audit Evidence

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

Inconsistency in, or Doubts over Reliability of, Audit Evidence

11. If:

    (a) audit evidence obtained from one source is inconsistent with that obtained from another; or

    (b) the auditor has doubts over the reliability of information to be used as audit evidence,

    the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A57)

Conformity and Compliance with International Standards on Auditing

12. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 500, *Audit Evidence*. Compliance with the requirements of this HKSA ensures compliance with ISA 500.

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Application and Other Explanatory Material

Sufficient Appropriate Audit Evidence (Ref: Para. 6)

A1. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit[6]) or a firm's quality control procedures for client acceptance and continuance. In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence.

A2. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

A3. As explained in HKSA 200,[7] reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

[6] HKSA 315 (Revised), paragraph 9

[7] HKSA 200, paragraph 5

A4. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A5. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

A6. HKSA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.[8] Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. HKSA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

Sources of Audit Evidence

A7. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

A8. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

A9. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties, analysts' reports, and comparable data about competitors (benchmarking data).

Audit Procedures for Obtaining Audit Evidence

A10. As required by, and explained further in, HKSA 315 (Revised) and HKSA 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(a) Risk assessment procedures; and

(b) Further audit procedures, which comprise:

(i) Tests of controls, when required by the HKSAs or when the auditor has chosen to do so; and

[8] HKSA 330, paragraph 26

(ii) Substantive procedures, including tests of details and substantive analytical procedures.

A11. The audit procedures described in paragraphs A14-A25 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in HKSA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.[9]

A12. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

A13. Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Inspection

A14. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

A15. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

A16. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation

A17. Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See HKSA 501 for further guidance on observation of the counting of inventory.[10]

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[9] HKSA 330, paragraph A35

[10] HKSA 501, *Audit Evidence—Specific Considerations for Selected Items*

External Confirmation

A18. An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. See HKSA 505 for further guidance.[11]

Recalculation

A19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

A20. Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

Analytical Procedures

A21. Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. See HKSA 520 for further guidance.

Inquiry

A22. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A23. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

A24. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a

[11] HKSA 505, *External Confirmations*

particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

A25. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries. See HKSA 580 for further guidance.[12]

Information to Be Used as Audit Evidence

Relevance and Reliability (Ref: Para. 7)

A26. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, and a firm's quality control procedures for client acceptance and continuance. The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance

A27. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A28. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cutoff. Similarly, obtaining audit evidence regarding a particular assertion, for example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

A29. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

A30. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

[12] HKSA 580, *Written Representations*

Reliability

A31. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalizations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.

- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).

- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).

- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

A32. HKSA 520 provides further guidance regarding the reliability of data used for purposes of designing analytical procedures as substantive procedures.[13]

A33. HKSA 240 deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.[14]

Reliability of Information Produced by a Management's Expert (Ref: Para. 8)

A34. The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

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[13] HKSA 520, paragraph 5(a)

[14] HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 13

A35. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this HKSA applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this HKSA, but is not the use of a management's expert by the entity.

A36. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this HKSA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities, and Objectivity of a Management's Expert (Ref: Para. 8(a))

A37. Competence relates to the nature and level of expertise of the management's expert. Capability relates the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.

A38. Information regarding the competence, capabilities and objectivity of a management's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.
- An auditor's expert, if any, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's expert.

A39. Matters relevant to evaluating the competence, capabilities and objectivity of a management's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A40. Other matters that may be relevant include:

- The relevance of the management's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialize in property and casualty insurance, but have limited expertise regarding pension calculations.
- The management's expert's competence with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.

A41. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).

A42. Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

A43. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management's Expert (Ref: Para. 8(b))

A44. An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's expert, or whether the auditor needs an auditor's expert for this purpose.[15]

A45. Aspects of the management's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.
- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the management's expert uses.

A46. In the case of a management's expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when obtaining an understanding of the work of the management's expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert; and
- The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A47. In the case of a management's expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding.

15 HKSA 620, *Using the Work of an Auditor's Expert*, paragraph 7

Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; and
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data.

Information Produced by the Entity and Used for the Auditor's Purposes (Ref: Para. 9(a)-(b))

A49. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorization), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

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

Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 10)

A52. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);

(b) Selecting specific items; and

(c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting All Items

A53. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

A54. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- *High value or key items*. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- *All items over a certain amount*. The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- *Items to obtain information*. The auditor may examine items to obtain information about matters such as the nature of the entity or the nature of transactions.

A55. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

Audit Sampling

A56. Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in HKSA 530.[16]

[16] HKSA 530, *Audit Sampling*

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

A57. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal auditors, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. HKSA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.[17]

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

HKSA 510
Issued September 2009; revised July 2010,
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Effective for audits of financial statements
for periods beginning on or after 15 December 2009

Hong Kong Standard on Auditing 510

Initial Audit Engagements —Opening Balances

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

HONG KONG STANDARD ON AUDITING 510

INITIAL AUDIT ENGAGEMENTS—OPENING BALANCES

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

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Hong Kong Standard on Auditing (HKSA) 510, *Initial Audit Engagements—Opening Balances*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to opening balances in an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments. When the financial statements include comparative financial information, the requirements and guidance in HKSA 710 [1] also apply. HKSA 300 [2] includes additional requirements and guidance regarding activities prior to starting an initial audit.

Effective Date

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

Objective

3. In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

   (a) Opening balances contain misstatements that materially affect the current period's financial statements; and

   (b) Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Definitions

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

   (a) Initial audit engagement – An engagement in which either:

      (i) The financial statements for the prior period were not audited; or

      (ii) The financial statements for the prior period were audited by a predecessor auditor.

   (b) Opening balances – Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

   (c) Predecessor auditor – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

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[1] HKSA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*

[2] HKSA 300, *Planning an Audit of Financial Statements*

Requirements

Audit Procedures

Opening Balances

5. The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

6. The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by: (Ref: Para. A1–A2)

   (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated;

   (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and

   (c) Performing one or more of the following: (Ref: Para. A3–A7)

      (i) Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;

      (ii) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or

      (iii) Performing specific audit procedures to obtain evidence regarding the opening balances.

7. If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance in accordance with HKSA 450.[3]

Consistency of Accounting Policies

8. The auditor shall obtain sufficient appropriate audit evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and whether changes in the accounting policies have been appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Relevant Information in the Predecessor Auditor's Report

9. If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the auditor shall evaluate the effect of the matter giving rise to the modification in assessing the risks of material misstatement in the current period's financial statements in accordance with HKSA 315 (Revised).[4]

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[3] HKSA 450, *Evaluation of Misstatements Identified during the Audit*, paragraphs 8 and 12

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

Audit Conclusions and Reporting

Opening Balances

10. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with HKSA 705 (Revised).[5] (Ref: Para. A8)

11. If the auditor concludes that the opening balances contain a misstatement that materially affects the current period's financial statements, and the effect of the misstatement is not appropriately accounted for or not adequately presented or disclosed, the auditor shall express a qualified opinion or an adverse opinion, as appropriate, in accordance with HKSA 705 (Revised).

Consistency of Accounting Policies

12. If the auditor concludes that:

    (a) the current period's accounting policies are not consistently applied in relation to opening balances in accordance with the applicable financial reporting framework; or

    (b) a change in accounting policies is not appropriately accounted for or not adequately presented or disclosed in accordance with the applicable financial reporting framework,

    the auditor shall express a qualified opinion or an adverse opinion as appropriate in accordance with HKSA 705 (Revised).

Modification to the Opinion in the Predecessor Auditor's Report

13. If the predecessor auditor's opinion regarding the prior period's financial statements included a modification to the auditor's opinion that remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements in accordance with HKSA 705 (Revised) and HKSA 710. (Ref: Para. A9)

Conformity and Compliance with International Standards on Auditing

14. As of September 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 510, *Initial Audit Engagements—Opening Balances*. Compliance with the requirements of this HKSA ensures compliance with ISA 510.

15. Additional local explanation and guidance is provided in footnote 5a and Appendix.

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Application and Other Explanatory Material

Audit Procedures

Considerations Specific to Public Sector Entities (Ref: Para. 6)

A1. In the public sector, there may be legal or regulatory limitations on the information that the current auditor can obtain from a predecessor auditor. For example, if a public sector entity that has previously been audited by a statutorily appointed auditor (for example, an Auditor

[5] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

General, or other suitably qualified person appointed on behalf of the Auditor General) is privatized, the amount of access to working papers or other information that the statutorily appointed auditor can provide a newly-appointed auditor that is in the private sector may be constrained by privacy or secrecy laws or regulations. In situations where such communications are constrained, audit evidence may need to be obtained through other means and, if sufficient appropriate audit evidence cannot be obtained, consideration given to the effect on the auditor's opinion.

A2. If the statutorily appointed auditor outsources an audit of a public sector entity to a private sector audit firm, and the statutorily appointed auditor appoints an audit firm other than the firm that audited the financial statements of the public sector entity in the prior period, this is not usually regarded as a change in auditors for the statutorily appointed auditor. Depending on the nature of the outsourcing arrangement, however, the audit engagement may be considered an initial audit engagement from the perspective of the private sector auditor in fulfilling the auditor's responsibilities, and therefore this HKSA applies.

Opening Balances (Ref: Para. 6(c))

A3. The nature and extent of audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances depend on such matters as:

- The accounting policies followed by the entity.
- The nature of the account balances, classes of transactions and disclosures and the risks of material misstatement in the current period's financial statements.
- The significance of the opening balances relative to the current period's financial statements.
- Whether the prior period's financial statements were audited and, if so, whether the predecessor auditor's opinion was modified.

A4. If the prior period's financial statements were audited by a predecessor auditor, the auditor may be able to obtain sufficient appropriate audit evidence regarding the opening balances by reviewing the predecessor auditor's working papers. Whether such a review provides sufficient appropriate audit evidence is influenced by the professional competence and independence of the predecessor auditor.

A5. Relevant ethical and professional requirements guide the current auditor's communications with the predecessor auditor.

A6. For current assets and liabilities, some audit evidence about opening balances may be obtained as part of the current period's audit procedures. For example, the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period. In the case of inventories, however, the current period's audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:

- Observing a current physical inventory count and reconciling it to the opening inventory quantities.
- Performing audit procedures on the valuation of the opening inventory items.
- Performing audit procedures on gross profit and cutoff.

A7. For non-current assets and liabilities, such as property, plant and equipment, investments and long-term debt, some audit evidence may be obtained by examining the accounting records and other information underlying the opening balances. In certain cases, the auditor may be able to obtain some audit evidence regarding opening balances through confirmation with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

Audit Conclusions and Reporting

Opening Balances (Ref: Para. 10)

A8. HKSA 705 (Revised) establishes requirements and provides guidance on circumstances that may result in a modification to the auditor's opinion on the financial statements, the type of opinion appropriate in the circumstances, and the content of the auditor's report when the auditor's opinion is modified. The inability of the auditor to obtain sufficient appropriate audit evidence regarding opening balances may result in one of the following modifications to the opinion in the auditor's report:

(a) A qualified opinion or a disclaimer of opinion, as is appropriate in the circumstances; or

(b) Unless prohibited by law or regulation, an opinion which is qualified or disclaimed, as appropriate, regarding the results of operations, and cash flows, where relevant, and unmodified regarding financial position.[5a]

The Appendix includes illustrative auditors' reports.

Modification to the Opinion in the Predecessor Auditor's Report (Ref: Para. 13)

A9. In some situations, a modification to the predecessor auditor's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case where, for example, there was a scope limitation in the prior period, but the matter giving rise to the scope limitation has been resolved in the current period.

[5a] This form of opinion is permitted in Hong Kong.

Appendix

(Ref: Para. A8)

Illustrations of Independent Auditors' Reports with Modified Opinions

Note: Throughout these illustrative auditor's reports, the Opinion section has been positioned first in accordance with HKSA 700 (Revised), and the Basis for Opinion section is positioned immediately after the Opinion section. Also, the first and last sentence that was included in the extant auditor's responsibilities section is now subsumed as part of the new Basis for Opinion section.

<u>Illustration 1:</u>

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600[1] does not apply).
- The financial statements are prepared by management of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.[2]
- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's financial performance and cash flows.[3]
- The financial position at year end is fairly presented.
- In this particular jurisdiction, law and regulation prohibit the auditor from giving an opinion which is qualified regarding the financial performance and cash flows and unmodified regarding financial position.[3a]
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).[4]

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

[2] HKSA 210, *Agreeing the Terms of Audit Engagements*

[3] If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's financial performance and cash flows, the auditor would disclaim an opinion on the financial performance and cash flows.

[3a] This form of opinion is permitted in Hong Kong.

[4] HKSA 570 (Revised), *Going Concern*

- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.[5]
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and has decided to do so.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements[6]

Qualified Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][6a] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA").

Basis for Qualified Opinion

We were appointed as auditors of the Company on 30 June 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 31 December 20X0. Since opening inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the financial performance for the year reported in the [statement of profit or loss and other comprehensive income][statement of profit or loss and statement of profit or loss and other comprehensive income][6a] and the net cash flows from operating activities reported in the statement of cash flows.

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[5] HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

[6] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[6a] HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Other Matter

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

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Management and Those Charged with Governance for the Financial Statements[7]

[*Reporting in accordance with HKSA 700 (Revised)*[8] *– see Illustration 3 in HKSA 700 (Revised*).]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[*Auditor's Address*]

[*Date*]

[7] Throughout these illustrative auditor's reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

[8] HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Illustration 2:

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor did not observe the counting of the physical inventory at the beginning of the current period and was unable to obtain sufficient appropriate audit evidence regarding the opening balances of inventory.
- The possible effects of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory are deemed to be material but not pervasive to the entity's financial performance and cash flows.[9]
- The financial position at year end is fairly presented.
- An opinion that is qualified regarding the financial performance and cash flows and unmodified regarding financial position is considered appropriate in the circumstances.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and has decided to do so.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

[9] If the possible effects, in the auditor's judgment, are considered to be material and pervasive to the entity's financial performance and cash flows, the auditor would disclaim the opinion on the financial performance and cash flows.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[9a]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][10a] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

Qualified Opinion on the Financial Performance and Cash Flows

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the [statement of profit or loss and other comprehensive income][statement of profit or loss and statement of profit or loss and other comprehensive income][10a] and statement of cash flows give a true and fair view of the financial performance and cash flows of the Company for the year ended 31 December 20X1 in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Opinion on the Financial Position

In our opinion, the statement of financial position gives a true and fair view of the financial position of the Company as at 31 December 20X1 in accordance with HKFRSs and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinions, Including Basis for Qualified Opinion on the Financial Performance and Cash Flows

We were appointed as auditors of the Company on 30 June 20X1 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 31 December 20X0. Since opening inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the financial performance for the year reported in the [statement of profit or loss and other comprehensive income][statement of profit or loss and statement of profit or loss and other comprehensive income][10a] and the net cash flows from operating activities reported in the statement of cash flows.

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and

[9a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[10] Not used.

[10a] HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our unmodified opinion on the financial position and our qualified audit opinion on the financial performance and cash flows.

Other Matter

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

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors' and Those Charged with Governance for the Financial Statements [11]

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

[11] Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

Report on Other Matters under sections 407(2)[12] and 407(3)[12] of the Hong Kong Companies Ordinance[13]

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding opening balances of inventory as described in the *Basis for Qualified Opinion* section of our report above:

- we were unable to determine whether adequate accounting records had been kept; and
- we have not obtained all the information and explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[*Auditor's Address*]

[*Date*]

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[12] Section 407 of the CO requires the auditor to opine on other matters:

(1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—

(a) whether adequate accounting records have been kept by the company; and

(b) whether the financial statements are in agreement with the accounting records.

(2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—

(a) adequate accounting records have not been kept by the company; or

(b) the financial statements are not in agreement with the accounting records in any material respect.

(3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.

(4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

[13] For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 (Revised), *Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)*.

HKSA 540

Issued July 2009; revised July 2010, August 2015, January 2016, June 2017

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

Hong Kong Standard on Auditing 540

Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

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

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HONG KONG STANDARD ON AUDITING 540

AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES

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

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Appendix: Fair Value Measurements and Disclosures under Different Financial Reporting Frameworks

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Hong Kong Standard on Auditing (HKSA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how HKSA 315 (Revised) [1] and HKSA 330 [2] and other relevant HKSAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Nature of Accounting Estimates

2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this HKSA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias. (Ref: Para. A1-A11)

3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as "marketplace participants" or equivalent) in an arm's length transaction, rather than the settlement of a transaction at some past or future date.[3]

4. A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.

Effective Date

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

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

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

[3] Different definitions of fair value may exist among financial reporting frameworks.

Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:

   (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and

   (b) related disclosures in the financial statements are adequate,

   in the context of the applicable financial reporting framework.

Definitions

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

   (a) Accounting estimate – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this HKSA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used.

   (b) Auditor's point estimate or auditor's range – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

   (c) Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

   (d) Management bias – A lack of neutrality by management in the preparation of information.

   (e) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

   (f) Outcome of an accounting estimate –The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Requirements

Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by HKSA 315 (Revised),[4] the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)

   (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. A13-A15)

[4] HKSA 315 (Revised), paragraphs 5-6 and 11-12

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16-A21)

(c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: (Ref: Para. A22-A23)

(i) The method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24-A26)

(ii) Relevant controls; (Ref: Para. A27-A28)

(iii) Whether management has used an expert; (Ref: Para. A29-A30)

(iv) The assumptions underlying the accounting estimates; (Ref: Para. A31-A36)

(v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and (Ref: Para. A37)

(vi) Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. A38)

9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time. (Ref: Para. A39-A44)

Identifying and Assessing the Risks of Material Misstatement

10. In identifying and assessing the risks of material misstatement, as required by HKSA 315 (Revised),[5] the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. (Ref: Para. A45-A46)

11. The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (Ref: Para. A47-A51)

Responses to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor shall determine: (Ref: Para. A52)

(a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (Ref: Para. A53-A56)

[5] HKSA 315 (Revised), paragraph 25

(b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (Ref: Para. A57-A58)

13. In responding to the assessed risks of material misstatement, as required by HKSA 330,[6] the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59-A61)

(a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62-A67)

(b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether: (Ref: Para. A68-A70)

(i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71-A76)

(ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77-A83)

(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84-A86)

(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87-A91)

(i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92)

(ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93-A95)

14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: Para. A96-A101)

Further Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of HKSA 330,[7] the auditor shall evaluate the following: (Ref: Para. A102)

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6 HKSA 330, paragraph 5

7 HKSA 330, paragraph 18

(a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103-A106)

(b) Whether the significant assumptions used by management are reasonable. (Ref: Para. A107-A109)

(c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111-A112)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:

(a) Management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and (Ref: Para. A113-A114)

(b) The selected measurement basis for the accounting estimates, (Ref: Para. A115)

are in accordance with the requirements of the applicable financial reporting framework.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements

18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116-A119)

Disclosures Related to Accounting Estimates

19. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework. (Ref: Para. A120-A121)

20. For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122-A123)

Indicators of Possible Management Bias

21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124-A125)

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable. (Ref: Para. A126-A127)

Documentation

23. The auditor shall include in the audit documentation:[8]

    (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and

    (b) Indicators of possible management bias, if any. (Ref: Para. A128)

Conformity and Compliance with International Standards on Auditing

24. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. Compliance with the requirements of this HKSA ensures compliance with ISA 540.

***

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. The Appendix to this HKSA discusses fair value measurements and disclosures under different financial reporting frameworks.

A2. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, for example:

- Accounting estimates arising in entities that engage in business activities that are not complex.

- Accounting estimates that are frequently made and updated because they relate to routine transactions.

- Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.

- Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.

- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

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

A3. For some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example:

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialized entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

A4. The degree of estimation uncertainty varies based on the nature of the accounting estimate, the extent to which there is a generally accepted method or model used to make the accounting estimate, and the subjectivity of the assumptions used to make the accounting estimate. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be made.

A5. Not all financial statement items requiring measurement at fair value involve estimation uncertainty. For example, this may be the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, in which case the existence of published price quotations ordinarily is the best audit evidence of fair value. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

A6. Additional examples of situations where accounting estimates, other than fair value accounting estimates, may be required include:

- Allowance for doubtful accounts.
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability.
- Outcome of long term contracts.
- Costs arising from litigation settlements and judgments.

A7. Additional examples of situations where fair value accounting estimates may be required include:

- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
- Property or equipment held for disposal.

- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.

- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

A8. Estimation involves judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The auditor is not responsible for predicting future conditions, transactions or events that, if known at the time of the audit, might have significantly affected management's actions or the assumptions used by management.

Management Bias

A9. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired result). The susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

Considerations Specific to Public Sector Entities

A11. Public sector entities may have significant holdings of specialized assets for which there are no readily available and reliable sources of information for purposes of measurement at fair value or other current value bases, or a combination of both. Often specialized assets held do not generate cash flows and do not have an active market. Measurement at fair value therefore ordinarily requires estimation and may be complex, and in some rare cases may not be possible at all.

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this HKSA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, and to plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:

- Prescribes certain conditions for the recognition,[9] or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability.
- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimate, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome.[10] Others may require, for example, use of a discounted probability-weighted expected value. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which the accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit an accounting estimate to be recognized in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of How Management Identifies the Need for Accounting Estimates (Ref: Para. 8(b))

A16. The preparation of the financial statements requires management to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognized, measured and disclosed in the financial statements in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.

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9 Most financial reporting frameworks require incorporation in the balance sheet or income statement of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognize such items, including accounting estimates.

10 Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

- Where applicable, management's cumulative experience of preparing the entity's financial statements in prior periods.

In such cases, the auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. In other cases, where management's process is more structured, for example, when management has a formal risk management function, the auditor may perform risk assessment procedures directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary. The completeness of accounting estimates is often an important consideration of the auditor, particularly accounting estimates relating to liabilities.

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assist the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for an accounting estimate.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes within the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. HKSA 315 (Revised) deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.[11]

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often limited and transactions are less complex. Further, often a single person, for example the owner-manager, identifies the need to make an accounting estimate and the auditor may focus inquiries accordingly.

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: Para. 8(c))

A22. The preparation of the financial statements also requires management to establish financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

[11] HKSA 315 (Revised), paragraph 16

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying relevant data and assumptions that affect accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).
- Whether and, if so, how management has used recognized measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: Para. 8(c)(i))

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, for example, a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method or, where applicable the model, used to make accounting estimates include, for example:

- How management considered the nature of the asset or liability being estimated when selecting a particular method.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A26. There may be greater risks of material misstatement, for example, in cases when management has internally developed a model to be used to make the accounting estimate or is departing from a method commonly used in a particular industry or environment.

Relevant Controls (Ref: Para. 8(c)(ii))

A27. Matters that the auditor may consider in obtaining an understanding of relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates.

- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance.

- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:

- The design and development, or selection, of a particular model for a particular purpose.

- The use of the model.

- The maintenance and periodic validation of the integrity of the model.

Management's Use of Experts (Ref: Para. 8(c)(iii))

A29. Management may have, or the entity may employ individuals with, the experience and competence necessary to make the required point estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialized nature of the matter requiring estimation, for example, the measurement of mineral or hydrocarbon reserves in extractive industries.

- The technical nature of the models required to meet the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements at fair value.

- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

Considerations specific to smaller entities

A30. In smaller entities, the circumstances requiring an accounting estimate often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner-manager in determining the need to use an expert.

Assumptions (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.

- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).

- Where applicable, how management determines that the assumptions used are internally consistent.

- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).

- The nature and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A32. In some cases, assumptions may be referred to as inputs, for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what knowledgeable, willing arm's length parties (sometimes referred to as "marketplace participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

(a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).

(b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as "unobservable inputs" or equivalent).

In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods for Making Accounting Estimates (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.

- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.

- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognized in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.

- Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.

- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.

A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by HKSA 240.[12] That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this HKSA may be carried out in conjunction with the review required by HKSA 240.

A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognized in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognized in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the preparation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

Identifying and Assessing the Risks of Material Misstatement

Estimation Uncertainty (Ref: Para. 10)

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in assumptions.

[12] HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii).

- The existence of recognized measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).

- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.

- The availability of reliable data from external sources.

- The extent to which the accounting estimate is based on observable or unobservable inputs.

The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to bias.

A46. Matters that the auditor considers in assessing the risks of material misstatement may also include:

- The actual or expected magnitude of an accounting estimate.

- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.

- Whether management has used an expert in making the accounting estimate.

- The outcome of the review of prior period accounting estimates.

High Estimation Uncertainty and Significant Risks (Ref: Para. 11)

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.

- Accounting estimates that are not calculated using recognized measurement techniques.

- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.

- Fair value accounting estimates for which a highly specialized entity-developed model is used or for which there are no observable inputs.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognized or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

A50. If the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.[13]

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. HKSA 570 (Revised)[14] establishes requirements and provides guidance in such circumstances.

Responses to the Assessed Risks of Material Misstatement (Ref: Para. 12)

A52. HKSA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.[15] Paragraphs A53-A115 focus on specific responses at the assertion level only.

Application of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 12(a))

A53. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.

A54. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.

A55. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.

A56. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.

Consistency in Methods and Basis for Changes (Ref: Para. 12(b))

A57. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

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[13] HKSA 315 (Revised), paragraph 29

[14] HKSA 570 (Revised), *Going Concern*

[15] HKSA 330, paragraphs 5-6

A58. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Responses to the Assessed Risks of Material Misstatements (Ref: Para. 13)

A59. The auditor's decision as to which response, individually or in combination, in paragraph 13 to undertake to respond to the risks of material misstatement may be influenced by such matters as:

- The nature of the accounting estimate, including whether it arises from routine or non routine transactions.
- Whether the procedure(s) is expected to effectively provide the auditor with sufficient appropriate audit evidence.
- The assessed risk of material misstatement, including whether the assessed risk is a significant risk.

A60. For example, when evaluating the reasonableness of the allowance for doubtful accounts, an effective procedure for the auditor may be to review subsequent cash collections in combination with other procedures. Where the estimation uncertainty associated with an accounting estimate is high, for example, an accounting estimate based on a proprietary model for which there are unobservable inputs, it may be that a combination of the responses to assessed risks in paragraph 13 is necessary in order to obtain sufficient appropriate audit evidence.

A61. Additional guidance explaining the circumstances in which each of the responses may be appropriate is provided in paragraphs A62-A95.

Events Occurring Up to the Date of the Auditor's Report (Ref: Para. 13(a))

A62. Determining whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate may be an appropriate response when such events are expected to:

- Occur; and
- Provide audit evidence that confirms or contradicts the accounting estimate.

A63. Events occurring up to the date of the auditor's report may sometimes provide sufficient appropriate audit evidence about an accounting estimate. For example, sale of the complete inventory of a superseded product shortly after the period end may provide audit evidence relating to the estimate of its net realizable value. In such cases, there may be no need to perform additional audit procedures on the accounting estimate, provided that sufficient appropriate evidence about the events is obtained.

A64. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate. Paragraph 13 identifies other responses to the risks of material misstatement that the auditor may undertake.

A65. In some cases, events that contradict the accounting estimate may indicate that management has ineffective processes for making accounting estimates, or that there is management bias in the making of accounting estimates.

A66. Even though the auditor may decide not to undertake this approach in respect of specific accounting estimates, the auditor is required to comply with HKSA 560.[16] The auditor is required to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified [17] and appropriately reflected in the financial statements.[18] Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under HKSA 560 is particularly relevant.

Considerations specific to smaller entities

A67. When there is a longer period between the balance sheet date and the date of the auditor's report, the auditor's review of events in this period may be an effective response for accounting estimates other than fair value accounting estimates. This may particularly be the case in some smaller owner-managed entities, especially when management does not have formalized control procedures over accounting estimates.

Testing How Management Made the Accounting Estimate (Ref: Para. 13(b))

A68. Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. It may also be appropriate when, for example:

- The accounting estimate is derived from the routine processing of data by the entity's accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is likely to be effective.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.

A69. Testing how management made the accounting estimate may involve, for example:

- Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant, and whether the accounting estimate has been properly determined using such data and management assumptions.
- Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
- Recalculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.

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16 HKSA 560, *Subsequent Events*

17 HKSA 560, paragraph 6

18 HKSA 560, paragraph 8

- Considering management's review and approval processes.

Considerations specific to smaller entities

A70. In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Smaller entities with active management involvement may not have extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Evaluating the method of measurement (Ref: Para. 13(b)(i))

A71. When the applicable financial reporting framework does not prescribe the method of measurement, evaluating whether the method used, including any applicable model, is appropriate in the circumstances is a matter of professional judgment.

A72. For this purpose, matters that the auditor may consider include, for example, whether:

- Management's rationale for the method selected is reasonable.

- Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method.

- The method is appropriate in the circumstances given the nature of the asset or liability being estimated and the requirements of the applicable financial reporting framework relevant to accounting estimates.

- The method is appropriate in relation to the business, industry and environment in which the entity operates.

A73. In some cases, management may have determined that different methods result in a range of significantly different estimates. In such cases, obtaining an understanding of how the entity has investigated the reasons for these differences may assist the auditor in evaluating the appropriateness of the method selected.

Evaluating the use of models

A74. In some cases, particularly when making fair value accounting estimates, management may use a model. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A75. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A76. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:

  - The model's theoretical soundness and mathematical integrity, including the appropriateness of model parameters.

    - The consistency and completeness of the model's inputs with market practices.
    - The model's output as compared to actual transactions.

- Appropriate change control policies and procedures exist.
- The model is periodically calibrated and tested for validity, particularly when inputs are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required inputs, and results of any validation analysis performed.

Assumptions used by management (Ref: Para. 13(b)(ii))

A77. The auditor's evaluation of the assumptions used by management is based only on information available to the auditor at the time of the audit. Audit procedures dealing with management assumptions are performed in the context of the audit of the entity's financial statements, and not for the purpose of providing an opinion on assumptions themselves.

A78. Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example:

- Whether individual assumptions appear reasonable.
- Whether the assumptions are interdependent and internally consistent.
- Whether the assumptions appear reasonable when considered collectively or in conjunction with other assumptions, either for that accounting estimate or for other accounting estimates.
- In the case of fair value accounting estimates, whether the assumptions appropriately reflect observable marketplace assumptions.

A79. The assumptions on which accounting estimates are based may reflect what management expects will be the outcome of specific objectives and strategies. In such cases, the auditor may perform audit procedures to evaluate the reasonableness of such assumptions by considering, for example, whether the assumptions are consistent with:

- The general economic environment and the entity's economic circumstances.
- The plans of the entity.
- Assumptions made in prior periods, if relevant.
- Experience of, or previous conditions experienced by, the entity, to the extent this historical information may be considered representative of future conditions or events.
- Other assumptions used by management relating to the financial statements.

A80. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorizations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

A81. Matters that the auditor may consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates, in addition to those discussed above, where applicable, may include, for example:

- Where relevant, whether and, if so, how management has incorporated market-specific inputs into the development of assumptions.
- Whether the assumptions are consistent with observable market conditions, and the characteristics of the asset or liability being measured at fair value.
- Whether the sources of market-participant assumptions are relevant and reliable, and how management has selected the assumptions to use when a number of different market participant assumptions exist.
- Where appropriate, whether and, if so, how management considered assumptions used in, or information about, comparable transactions, assets or liabilities.

A82. Further, fair value accounting estimates may comprise observable inputs as well as unobservable inputs. Where fair value accounting estimates are based on unobservable inputs, matters that the auditor may consider include, for example, how management supports the following:

- The identification of the characteristics of marketplace participants relevant to the accounting estimate.
- Modifications it has made to its own assumptions to reflect its view of assumptions marketplace participants would use.
- Whether it has incorporated the best information available in the circumstances.

- Where applicable, how its assumptions take account of comparable transactions, assets or liabilities.

If there are unobservable inputs, it is more likely that the auditor's evaluation of the assumptions will need to be combined with other responses to assessed risks in paragraph 13 in order to obtain sufficient appropriate audit evidence. In such cases, it may be necessary for the auditor to perform other audit procedures, for example, examining documentation supporting the review and approval of the accounting estimate by appropriate levels of management and, where appropriate, by those charged with governance.

A83. In evaluating the reasonableness of the assumptions supporting an accounting estimate, the auditor may identify one or more significant assumptions. If so, it may indicate that the accounting estimate has high estimation uncertainty and may, therefore, give rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

Testing the Operating Effectiveness of Controls (Ref: Para. 13(c))

A84. Testing the operating effectiveness of the controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.

- The accounting estimate is derived from the routine processing of data by the entity's accounting system.

A85. Testing the operating effectiveness of the controls is required when:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or

(b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.[19]

Considerations specific to smaller entities

A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

Developing a Point Estimate or Range (Ref: Para. 13(d))

A87. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response where, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.

[19] HKSA 330, paragraph 8

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.

- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.

- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.

- There are alternative sources of relevant data available to the auditor which can be used in developing a point estimate or a range.

A88. Even where the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A89. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A90. The ability of the auditor to develop a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value).

A91. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.

- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.

- Employing or engaging a person with specialized expertise to develop or execute the model, or to provide relevant assumptions.

- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

Understanding Management's Assumptions or Method (Ref: Para. 13(d)(i))

A92. When the auditor develops a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management.

This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

Narrowing a Range (Ref: Para. 13(d)(ii))

A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A94. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102-A115.

A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

(a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and

(b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

Considering Whether Specialized Skills or Knowledge Are Required (Ref: Para. 14)

A96. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement.[20] This may include, as necessary, the involvement of those with specialized skills or knowledge. In addition, HKSA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement.[21] During the course of the audit of accounting estimates the auditor may identify, in light of the experience of the auditor and the circumstances of the engagement, the need for specialized skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

[20] HKSA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

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

A97. Matters that may affect the auditor's consideration of whether specialized skills or knowledge is required include, for example:

- The nature of the underlying asset, liability or component of equity in a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments).
- A high degree of estimation uncertainty.
- Complex calculations or specialized models are involved, for example, when estimating fair values when there is no observable market.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.

A98. For the majority of accounting estimates, even when there is estimation uncertainty, it is unlikely that specialized skills or knowledge will be required. For example, it is unlikely that specialized skills or knowledge would be necessary for an auditor to evaluate an allowance for doubtful accounts.

A99. However, the auditor may not possess the specialized skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. HKSA 620[22] establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A100. Further, in some cases, the auditor may conclude that it is necessary to obtain specialized skills or knowledge related to specific areas of accounting or auditing. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organization outside of the auditor's firm. Where such individuals perform audit procedures on the engagement, they are part of the engagement team and accordingly, they are subject to the requirements in HKSA 220.

A101. Depending on the auditor's understanding and experience of working with the auditor's expert or those other individuals with specialized skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Further Substantive Procedures to Respond to Significant Risks (Ref: Para. 15)

A102. In auditing accounting estimates that give rise to significant risks, the auditor's further substantive procedures are focused on the evaluation of:

(a) How management has assessed the effect of estimation uncertainty on the accounting estimate, and the effect such uncertainty may have on the appropriateness of the recognition of the accounting estimate in the financial statements; and

(b) The adequacy of related disclosures.

[22] HKSA 620, *Using the Work of an Auditor's Expert*

Estimation Uncertainty

Management's Consideration of Estimation Uncertainty (Ref: Para. 15(a))

A103. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A104. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

A105. This is not intended to suggest that one particular method of addressing estimation uncertainty (such as sensitivity analysis) is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed how estimation uncertainty may affect the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

Considerations specific to smaller entities

A106. Smaller entities may use simple means to assess the estimation uncertainty. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation of the financial statements.

Significant Assumptions (Ref: Para. 15(b))

A107. An assumption used in making an accounting estimate may be deemed to be significant if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate.

A108. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

A109. The auditor's considerations in evaluating assumptions made by management are described in paragraphs A77-A83.

Management Intent and Ability (Ref: Para. 15(c))

A110. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs A13 and A80.

Development of a Range (Ref: Para. 16)

A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87-A95.

Recognition and Measurement Criteria

Recognition of the Accounting Estimates in the Financial Statements (Ref: Para. 17(a))

A113. Where management has recognized an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

A114. With respect to accounting estimates that have not been recognized, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. Where applicable, the auditor may also determine that an accounting estimate that has been identified as having a high estimation uncertainty is a key audit matter to be communicated in the auditor's report in accordance with HKSA 701,[23] or may consider it necessary to include an Emphasis of Matter paragraph in the auditor's report (see HKSA 706 (Revised)).[24] If the matter is determined to be a key audit matter, HKSA 706 (Revised) prohibits the auditor from including an Emphasis of Matter paragraph in the auditor's report.[25]

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[23] HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

[24] HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

[25] HKSA 706 (Revised), paragraph 8(b)

Measurement Basis for the Accounting Estimates (Ref: Para. 17(b))

A115. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements (Ref: Para. 18)

A116. Based on the audit evidence obtained, the auditor may conclude that the evidence points to an accounting estimate that differs from management's point estimate. Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is no less than the difference between management's point estimate and the nearest point of the auditor's range.

A117. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124-A125).

A118. HKSA 450[26] provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.

A119. Evaluating the reasonableness of accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.

26 HKSA 450, *Evaluation of Misstatements Identified during the Audit*

Disclosures Related to Accounting Estimates

Disclosures in Accordance with the Applicable Financial Reporting Framework (Ref: Para. 19)

A120. The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognized or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A121. In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as "Key Sources of Estimation Uncertainty" or "Critical Accounting Estimates."
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the entity's financial position and performance.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity's objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

Disclosures of Estimation Uncertainty for Accounting Estimates that Give Rise to Significant Risks (Ref: Para. 20)

A122. In relation to accounting estimates having significant risk, even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A94).

A123. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. HKSA 705 (Revised)[27] provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading.

Indicators of Possible Management Bias (Ref: Para. 21)

A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in HKSA 700 (Revised).[28]

A125. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Written Representations (Ref: Para. 22)

A126. HKSA 580[29] discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognized or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework, and the consistency in application of the processes.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates are complete and appropriate under the applicable financial reporting framework.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

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[27] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

[28] HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

[29] HKSA 580, *Written Representations*

A127. For those accounting estimates not recognized or disclosed in the financial statements, written representations may also include representations about:

- The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).

- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).

Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A125 for examples of indicators of possible management bias.

Appendix

(Ref: Para. A1)

Fair Value Measurements and Disclosures under Different Financial Reporting Frameworks

The purpose of this appendix is only to provide a general discussion of fair value measurements and disclosures under different financial reporting frameworks, for background and context.

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Definitions of fair value may differ among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, Hong Kong Accounting Standard (HKAS) 39[1] defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction." The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur. Additionally, different financial reporting frameworks may use such terms as "entity-specific value," "value in use," or similar terms, but may still fall within the concept of fair value in this HKSA.

3. Financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management's intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:

   - Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information;

   - Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met;

   - Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows;

   - Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework); or

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[1] HKAS 39, *Financial Instruments: Recognition and Measurement*

- Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. Some financial reporting frameworks may specify a fair value hierarchy that distinguishes inputs for use in arriving at fair values ranging from those that involve clearly "observable inputs" based on quoted prices and active markets and those "unobservable inputs" that involve an entity's own judgments about assumptions that marketplace participants would use.

6. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property's condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications. Further, in some cases, collateral assigned (for example, when collateral is assigned for certain types of investment in debt) may need to be considered in determining the fair value or possible impairment of an asset or liability.

7. In most financial reporting frameworks, underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, in this case, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. On the other hand, general economic conditions or economic conditions specific to certain industries may cause illiquidity in the marketplace and require fair values to be predicated upon depressed prices, potentially significantly depressed prices. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management's plan to dispose of an asset on an accelerated basis to meet specific business objectives may be relevant to the determination of the fair value of that asset.

Prevalence of Fair Value Measurements

8. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the determination of, financial statements in a number of ways, including the measurement at fair value of the following:

   - Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument, routinely or periodically "marked-to-market."

- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.

- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.

- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity's or unit's group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.

- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity's applicable financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.

- Information disclosed in notes to financial statements or presented as supplementary information, but not recognized in the financial statements.

HKSA 560

Issued July 2009; revised July 2010, August 2015, June 2017

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

Hong Kong Standard on Auditing 560

Subsequent Events

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HONG KONG STANDARD ON AUDITING 560

SUBSEQUENT EVENTS

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

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Hong Kong Standard on Auditing (HKSA) 560, *Subsequent Events*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to subsequent events in an audit of financial statements. It does not deal with matters relating to the auditor's responsibilities for other information obtained after the date of the auditor's report, which are addressed in HKSA 720 (Revised).[1] However, such other information may bring to light a subsequent event that is within the scope of this HKSA. (Ref: Para. A1)

Subsequent Events

2. Financial statements may be affected by certain events that occur after the date of the financial statements. Many financial reporting frameworks specifically refer to such events.[2] Such financial reporting frameworks ordinarily identify two types of events:

   (a) Those that provide evidence of conditions that existed at the date of the financial statements; and

   (b) Those that provide evidence of conditions that arose after the date of the financial statements.

   HKSA 700 (Revised) explains that the date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor becomes aware and that occurred up to that date.[3]

Effective Date

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

Objectives

4. The objectives of the auditor are:

   (a) To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework; and

   (b) To respond appropriately to facts that become known to the auditor after the date of the auditor's report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor's report.

Definitions

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

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1 HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

2 For example, Hong Kong Accounting Standard (HKAS) 10, *Events After the Reporting Period* deals with the treatment in financial statements of events, both favorable and unfavorable, that occur between the date of the financial statements (referred to as the "end of the reporting period" in the HKAS) and the date when the financial statements are authorized for issue.

3 HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph A66.

(a) Date of the financial statements – The date of the end of the latest period covered by the financial statements.

(b) Date of approval of the financial statements – The date on which all the statements that comprise the financial statements, including the related notes, have been prepared and those with the recognized authority have asserted that they have taken responsibility for those financial statements. (Ref: Para. A2)

(c) Date of the auditor's report – The date the auditor dates the report on the financial statements in accordance with HKSA 700 (Revised). (Ref: Para. A3)

(d) Date the financial statements are issued – The date that the auditor's report and audited financial statements are made available to third parties. (Ref: Para. A4-A5)

(e) Subsequent events – Events occurring between the date of the financial statements and the date of the auditor's report, and facts that become known to the auditor after the date of the auditor's report.

Requirements

Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report

6. The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified. The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions. (Ref: Para. A6)

7. The auditor shall perform the procedures required by paragraph 6 so that they cover the period from the date of the financial statements to the date of the auditor's report, or as near as practicable thereto. The auditor shall take into account the auditor's risk assessment in determining the nature and extent of such audit procedures, which shall include the following: (Ref: Para. A7-A8)

   (a) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.

   (b) Inquiring of management and, where appropriate, those charged with governance as to whether any subsequent events have occurred which might affect the financial statements. (Ref: Para. A9)

   (c) Reading minutes, if any, of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available. (Ref: Para. A10)

   (d) Reading the entity's latest subsequent interim financial statements, if any.

8. If, as a result of the procedures performed as required by paragraphs 6 and 7, the auditor identifies events that require adjustment of, or disclosure in, the financial statements, the auditor shall determine whether each such event is appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

Written Representations

9. The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with HKSA 580 [4] that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements are Issued

10. The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall: (Ref: Para. A11-A12)

    (a) Discuss the matter with management and, where appropriate, those charged with governance;

    (b) Determine whether the financial statements need amendment and, if so,

    (c) Inquire how management intends to address the matter in the financial statements.

11. If management amends the financial statements, the auditor shall:

    (a) Carry out the audit procedures necessary in the circumstances on the amendment.

    (b) Unless the circumstances in paragraph 12 apply:

        (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report; and

        (ii) Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

12. Where law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events required in paragraph 11(b)(i) to that amendment. In such cases, the auditor shall either:

    (a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or (Ref: Para. A13)

    (b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph [5] or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

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[4] HKSA 580, *Written Representations*

[5] See HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

13. In some jurisdictions, management may not be required by law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, if management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then: (Ref: Para. A14-A15)

    (a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by HKSA 705 (Revised) [6] and then provide the auditor's report; or

    (b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref. Para: A16-A17)

Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued

14. After the financial statements have been issued, the auditor has no obligation to perform any audit procedures regarding such financial statements. However, if, after the financial statements have been issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

    (a) Discuss the matter with management and, where appropriate, those charged with governance;

    (b) Determine whether the financial statements need amendment; and, if so,

    (c) Inquire how management intends to address the matter in the financial statements. (Ref: Para. A18)

15. If management amends the financial statements, the auditor shall: (Ref: Para. A19)

    (a) Carry out the audit procedures necessary in the circumstances on the amendment.

    (b) Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.

    (c) Unless the circumstances in paragraph 12 apply:

        (i) Extend the audit procedures referred to in paragraphs 6 and 7 to the date of the new auditor's report, and date the new auditor's report no earlier than the date of approval of the amended financial statements; and

        (ii) Provide a new auditor's report on the amended financial statements.

    (d) When the circumstances in paragraph 12 apply, amend the auditor's report, or provide a new auditor's report as required by paragraph 12.

[6] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

16. The auditor shall include in the new or amended auditor's report an Emphasis of Matter paragraph or Other Matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided by the auditor.

17. If management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation and does not amend the financial statements in circumstances where the auditor believes they need to be amended, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity,[7] those charged with governance, that the auditor will seek to prevent future reliance on the auditor's report. If, despite such notification, management or those charged with governance do not take these necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report. (Ref: Para. A20)

Conformity and Compliance with International Standards on Auditing

18. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 560, *Subsequent Events*. Compliance with the requirements of this HKSA ensures compliance with ISA 560.

***

Application and Other Explanatory Material

Scope of this HKSA (Ref: Para. 1)

A1. When the audited financial statements are included in other documents subsequent to the issuance of the financial statements (other than annual reports that would be within the scope of HKSA 720 (Revised)), the auditor may have additional responsibilities relating to subsequent events that the auditor may need to consider, such as legal or regulatory requirements involving the offering of securities to the public in jurisdictions in which the securities are being offered. For example, the auditor may be required to perform additional audit procedures to the date of the final offering document. These procedures may include those referred to in paragraphs 6 and 7 performed up to a date at or near the effective date of the final offering document, and reading the offering document to assess whether the other information in the offering document is consistent with the financial information with which the auditor is associated.[8]

Definitions

Date of Approval of the Financial Statements (Ref: Para. 5(b))

A2. In some jurisdictions, law or regulation identifies the individuals or bodies (for example, management or those charged with governance) that are responsible for concluding that all the statements that comprise the financial statements, including the related notes, have been prepared, and specifies the necessary approval process. In other jurisdictions, the approval process is not prescribed in law or regulation and the entity follows its own procedures in preparing and finalizing its financial statements in view of its management and governance structures. In some jurisdictions, final approval of the financial statements by shareholders is required. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements has been obtained. The date of approval of the financial statements for purposes of the HKSAs is the earlier date on which those with the recognized

[7] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

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

authority determine that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Date of the Auditor's Report (Ref: Para. 5(c))

A3. The auditor's report cannot be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements, including evidence that all the statements that comprise the financial statements, including the related notes, have been prepared and that those with the recognized authority have asserted that they have taken responsibility for those financial statements.[9] Consequently, the date of the auditor's report cannot be earlier than the date of approval of the financial statements as defined in paragraph 5(b). A time period may elapse due to administrative issues between the date of the auditor's report as defined in paragraph 5(c) and the date the auditor's report is provided to the entity.

Date the Financial Statements Are Issued (Ref: Para. 5(d))

A4. The date the financial statements are issued generally depends on the regulatory environment of the entity. In some circumstances, the date the financial statements are issued may be the date that they are filed with a regulatory authority. Since audited financial statements cannot be issued without an auditor's report, the date that the audited financial statements are issued must not only be at or later than the date of the auditor's report, but must also be at or later than the date the auditor's report is provided to the entity.

Considerations Specific to Public Sector Entities

A5. In the case of the public sector, the date the financial statements are issued may be the date the audited financial statements and the auditor's report thereon are presented to the legislature or otherwise made public.

Events Occurring between the Date of the Financial Statements and the Date of the Auditor's Report (Ref: Para. 6-9)

A6. Depending on the auditor's risk assessment, the audit procedures required by paragraph 6 may include procedures, necessary to obtain sufficient appropriate audit evidence, involving the review or testing of accounting records or transactions occurring between the date of the financial statements and the date of the auditor's report. The audit procedures required by paragraphs 6 and 7 are in addition to procedures that the auditor may perform for other purposes that, nevertheless, may provide evidence about subsequent events (for example, to obtain audit evidence for account balances as at the date of the financial statements, such as cutoff procedures or procedures in relation to subsequent receipts of accounts receivable).

A7. Paragraph 7 stipulates certain audit procedures in this context that the auditor is required to perform pursuant to paragraph 6. The subsequent events procedures that the auditor performs may, however, depend on the information that is available and, in particular, the extent to which the accounting records have been prepared since the date of the financial statements. Where the accounting records are not up-to-date, and accordingly no interim financial statements (whether for internal or external purposes) have been prepared, or minutes of meetings of management or those charged with governance have not been prepared, relevant audit procedures may take the form of inspection of available books and records, including bank statements. Paragraph A8 gives examples of some of the additional matters that the auditor may consider in the course of these inquiries.

[9] HKSA 700 (Revised), paragraph 49. In some cases, law or regulation also identifies the point in the financial statement reporting process at which the audit is expected to be complete.

A8. In addition to the audit procedures required by paragraph 7, the auditor may consider it necessary and appropriate to:

- Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements;

- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims; or

- Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

Inquiry (Ref: Para. 7(b))

A9. In inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:

- Whether new commitments, borrowings or guarantees have been entered into.

- Whether sales or acquisitions of assets have occurred or are planned.

- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.

- Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.

- Whether there have been any developments regarding contingencies.

- Whether any unusual accounting adjustments have been made or are contemplated.

- Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements, as would be the case, for example, if such events call into question the validity of the going concern assumption.

- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.

- Whether any events have occurred that are relevant to the recoverability of assets.

Reading Minutes (Ref: Para. 7(c))

Considerations Specific to Public Sector Entities

A10. In the public sector, the auditor may read the official records of relevant proceedings of the legislature and inquire about matters addressed in proceedings for which official records are not yet available.

Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements are Issued

Implications of Other Information Obtained after the Date of the Auditor's Report (Ref: Para. 10)

A11. While the auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report but before the date the financial statements are issued, HKSA 720 (Revised) contains requirements and guidance with respect to other information obtained after the date of the auditor's report, which might include other information obtained after the date of the auditor's report, but before the date the financial statements are issued.

Management Responsibility towards Auditor (Ref: Para. 10)

A12. As explained in HKSA 210, the terms of the audit engagement include the agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.[10]

Dual Dating (Ref: Para. 12(a))

A13. When, in the circumstances described in paragraph 12(a), the auditor amends the auditor's report to include an additional date restricted to that amendment, the date of the auditor's report on the financial statements prior to their subsequent amendment by management remains unchanged because this date informs the reader as to when the audit work on those financial statements was completed. However, an additional date is included in the auditor's report to inform users that the auditor's procedures subsequent to that date were restricted to the subsequent amendment of the financial statements. The following is an illustration of such an additional date:

> (Date of auditor's report), except as to Note Y, which is as of (date of completion of audit procedures restricted to amendment described in Note Y).

No Amendment of Financial Statements by Management (Ref: Para. 13)

A14. In some jurisdictions, management may not be required by law, regulation or the financial reporting framework to issue amended financial statements. This is often the case when issuance of the financial statements for the following period is imminent, provided appropriate disclosures are made in such statements.

Considerations Specific to Public Sector Entities

A15. In the public sector, the actions taken in accordance with paragraph 13 when management does not amend the financial statements may also include reporting separately to the legislature, or other relevant body in the reporting hierarchy, on the implications of the subsequent event for the financial statements and the auditor's report.

Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 13(b))

A16. The auditor may need to fulfill additional legal obligations even when the auditor has notified management not to issue the financial statements and management has agreed to this request.

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[10] HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraph A24.

A17. Where management has issued the financial statements despite the auditor's notification not to issue the financial statements to third parties, the auditor's course of action to prevent reliance on the auditor's report on the financial statements depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

Facts Which Become Known to the Auditor after the Financial Statements Have Been Issued

Implications of Other Information Received after the Financial Statements Have Been Issued (Ref: Para. 14)

A18. The auditor's obligations regarding other information received after the date of the auditor's report are addressed in HKSA 720 (Revised). While the auditor has no obligation to perform any audit procedures regarding the financial statements after the financial statements have been issued, HKSA 720 (Revised) contains requirements and guidance with respect to other information obtained after the date of the auditor's report.

No Amendment of Financial Statements by Management (Ref: Para. 15)

Considerations Specific to Public Sector Entities

A19. In some jurisdictions, entities in the public sector may be prohibited from issuing amended financial statements by law or regulation. In such circumstances, the appropriate course of action for the auditor may be to report to the appropriate statutory body.

Auditor Action to Seek to Prevent Reliance on Auditor's Report (Ref: Para. 17)

A20. Where the auditor believes that management, or those charged with governance, have failed to take the necessary steps to prevent reliance on the auditor's report on financial statements previously issued by the entity despite the auditor's prior notification that the auditor will take action to seek to prevent such reliance, the auditor's course of action depends upon the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

HKSA 570 (Revised)

Issued August 2015; revised June 2017

Effective for audits of financial statements

for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 570 (Revised)

Going Concern

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

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HONG KONG STANDARD ON AUDITING 570 (REVISED) GOING CONCERN

(Effective for audits of financial statements for periods ending on or after 15 December 2016)

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Hong Kong Standard on Auditing (HKSA) 570 (Revised), *Going Concern*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgment regarding the outcome of events or conditions.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events may result in outcomes that are inconsistent with judgments that were reasonable at the time they were made.

Responsibilities of the Auditor

6. The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. These responsibilities exist even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

7. However, as described in HKSA 200,[2] the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for future events or conditions that may cause an entity to cease to continue as a going concern. The auditor cannot predict such future events or conditions. Accordingly, the absence of any reference to a material uncertainty about the entity's ability to continue as a going concern in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Effective Date

8. This HKSA is effective for audits of financial statements for periods ending on or after 15 December 2016.

Objectives

9. The objectives of the auditor are:

   (a) To obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements;

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

   (c) To report in accordance with this HKSA.

Requirements

Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures as required by HKSA 315 (Revised),[3] the auditor shall consider whether events or conditions exist that may cast significant doubt on the entity's

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[2] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraphs A53–A54

[3] HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 5

- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Evaluating the entity's plans to deal with unfilled customer orders.
- Performing audit procedures regarding subsequent events to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.
- Confirming the existence, terms and adequacy of borrowing facilities.
- Obtaining and reviewing reports of regulatory actions.
- Determining the adequacy of support for any planned disposals of assets.

Evaluating Management's Plans for Future Actions (Ref: Para. 16(b))

A17. Evaluating management's plans for future actions may include inquiries of management as to its plans for future action, including, for example, its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

The Period of Management's Assessment (Ref: Para. 16(c))

A18. In addition to the procedures required in paragraph 16(c), the auditor may compare:

- The prospective financial information for recent prior periods with historical results; and
- The prospective financial information for the current period with results achieved to date.

A19. Where management's assumptions include continued support by third parties, whether through the subordination of loans, commitments to maintain or provide additional funding, or guarantees, and such support is important to an entity's ability to continue as a going concern, the auditor may need to consider requesting written confirmation (including of terms and conditions) from those third parties and to obtain evidence of their ability to provide such support.

Written Representations (Ref: Para. 16(e))

A20. The auditor may consider it appropriate to obtain specific written representations beyond those required in paragraph 16 in support of audit evidence obtained regarding management's plans for future actions in relation to its going concern assessment and the feasibility of those plans.

Auditor Conclusions

Material Uncertainty Related to Events or Conditions that May Cast Significant Doubt on the Entity's Ability to Continue as a Going Concern (Ref: Para. 18)

A21. The phrase "material uncertainty" is used in HKAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.

the audit evidence obtained, the auditor concludes that no material uncertainty exists, and no disclosures are explicitly required by the applicable financial reporting framework regarding these circumstances.

Implications for the Auditor's Report

Use of Going Concern Basis of Accounting is Inappropriate (Ref: Para. 21)

A26. If the financial statements have been prepared using the going concern basis of accounting but, in the auditor's judgment, management's use of the going concern basis of accounting in the financial statements is inappropriate, the requirement in paragraph 21 for the auditor to express an adverse opinion applies regardless of whether or not the financial statements include disclosure of the inappropriateness of management's use of the going concern basis of accounting.

A27. When the use of the going concern basis of accounting is not appropriate in the circumstances, management may be required, or may elect, to prepare the financial statements on another basis (e.g., liquidation basis). The auditor may be able to perform an audit of those financial statements provided that the auditor determines that the other basis of accounting is acceptable in the circumstances. The auditor may be able to express an unmodified opinion on those financial statements, provided there is adequate disclosure therein about the basis of accounting on which the financial statements are prepared, but may consider it appropriate or necessary to include an Emphasis of Matter paragraph in accordance with HKSA 706 (Revised)[14] in the auditor's report to draw the user's attention to that alternative basis of accounting and the reasons for its use.

Use of the Going Concern Basis of Accounting Is Appropriate but a Material Uncertainty Exists (Ref: Para. 22–23)

A28. The identification of a material uncertainty is a matter that is important to users' understanding of the financial statements. The use of a separate section with a heading that includes reference to the fact that a material uncertainty related to going concern exists alerts users to this circumstance.

A29. The Appendix to this HKSA provides illustrations of the statements that are required to be included in the auditor's report on the financial statements when Hong Kong Financial Reporting Standards (HKFRSs) is the applicable financial reporting framework. If an applicable financial reporting framework other than HKFRSs is used, the illustrative statements presented in the Appendix to this HKSA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

A30. Paragraph 22 establishes the minimum information required to be presented in the auditor's report in each of the circumstances described. The auditor may provide additional information to supplement the required statements, for example to explain:

- That the existence of a material uncertainty is fundamental to users' understanding of the financial statements;[15] or
- How the matter was addressed in the audit. (see also paragraph A1)

[14] HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

[15] HKSA 706 (Revised), paragraph A2

Appendix

(Ref: Para. A29, A31–A32)

Illustrations of Independent Auditor's Reports Relating to Going Concern

- Illustration 1: An auditor's report containing an unmodified opinion when the auditor has concluded that a material uncertainty exists and disclosure in the financial statements is adequate.
- Illustration 2: An auditor's report containing a qualified opinion when the auditor has concluded that a material uncertainty exists and that the financial statements are materially misstated due to inadequate disclosure.
- Illustration 3: An auditor's report containing an adverse opinion when the auditor has concluded that a material uncertainty exists and the financial statements omit the required disclosures relating to a material uncertainty.

Illustration 1 – Unmodified Opinion When a Material Uncertainty Exists and Disclosure in the Financial Statements Is Adequate

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600[1] does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.[2]
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. The disclosure of the material uncertainty in the financial statements is adequate.
- Key audit matters have been communicated in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not yet identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[2a]

Report on the Audit of the Financial Statements[3]

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][3a] the statement of profit or loss and other comprehensive income, statement of changes

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

2 HKSA 210, *Agreeing the Terms of Audit Engagements*

2a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

3 The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

3a HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note XXX in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended 31 December 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Material Uncertainty Related to Going Concern* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[*Description of each key audit matter in accordance with HKSA 701.*]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[4]

[Reporting in accordance with HKSA 700 (Revised) – see Illustration 1 in HKSA 700 (Revised).[5]]

4 Throughout these illustrative auditor's reports, the terms directors and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

5 Paragraphs 34 and 39 of HKSA 700 (Revised) require wording to be included in the auditor's report for all entities in relation to going concern to describe the respective responsibilities of those responsible for the financial statements and the auditor in relation to going concern.

HKSA 580
Issued July 2009; revised July 2010, June 2014, August 2015, January 2016, August 2016, June 2017

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

Hong Kong Standard on Auditing 580

Written Representations

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

HONG KONG STANDARD ON AUDITING 580

WRITTEN REPRESENTATIONS

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

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Hong Kong Standard on Auditing (HKSA) 580, *Written Representations*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to obtain written representations from management and, where appropriate, those charged with governance in an audit of financial statements.

2. Appendix 1 lists other HKSAs containing subject-matter specific requirements for written representations. The specific requirements for written representations of other HKSAs do not limit the application of this HKSA.

Written Representations as Audit Evidence

3. Audit evidence is the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.[1] Written representations are necessary information that the auditor requires in connection with the audit of the entity's financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. (Ref: Para. A1)

4. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Furthermore, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

Effective Date

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

Objectives

6. The objectives of the auditor are:

   (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;

   (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other HKSAs; and

   (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

[1] HKSA 500, *Audit Evidence*, paragraph 5(c)

Definitions

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

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

8. For purposes of this HKSA, references to "management" should be read as "management and, where appropriate, those charged with governance." Furthermore, in the case of a fair presentation framework, management is responsible for the preparation and *fair* presentation of the financial statements in accordance with the applicable financial reporting framework; or the preparation of financial statements *that give a true and fair view* in accordance with the applicable financial reporting framework.

Requirements

Management from whom Written Representations Requested

9. The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A2-A6)

Written Representations about Management's Responsibilities

Preparation of the Financial Statements

10. The auditor shall request management [1a] to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation, as set out in the terms of the audit engagement.[2] (Ref: Para. A7-A9, A14, A22)

Information Provided and Completeness of Transactions

11. The auditor shall request management to provide a written representation that:

    (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement;[3] and

    (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7-A9, A14, A22)

Description of Management's Responsibilities in the Written Representations

12. Management's responsibilities shall be described in the written representations required by paragraphs 10 and 11 in the manner in which these responsibilities are described in the terms of the audit engagement.

[1a] Under the Companies Ordinance, the directors are responsible for the preparation of financial statements showing a true and fair view.

[2] HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(b)(i)

[3] HKSA 210, paragraph 6(b)(iii)

Other Written Representations

13. Other HKSAs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (Ref: Para. A10-A13, A14, A22)

Date of and Period(s) Covered by Written Representations

14. The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor's report. (Ref: Para. A15-A18)

Form of Written Representations

15. The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by paragraphs 10 or 11, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A19-A21)

Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided

Doubt as to the Reliability of Written Representations

16. If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A24-A25)

17. In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A23)

18. If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with HKSA 705 (Revised),[4] having regard to the requirement in paragraph 20 of this HKSA.

Requested Written Representations Not Provided

19. If management does not provide one or more of the requested written representations, the auditor shall:

    (a) Discuss the matter with management;

    (b) Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

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[4] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

(c) Take appropriate actions, including determining the possible effect on the opinion in the auditor's report in accordance with HKSA 705 (Revised), having regard to the requirement in paragraph 20 of this HKSA.

Written Representations about Management's Responsibilities

20. The auditor shall disclaim an opinion on the financial statements in accordance with HKSA 705 (Revised) if:

(a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 10 and 11 are not reliable; or

(b) Management does not provide the written representations required by paragraphs 10 and 11. (Ref: Para. A26-A27)

Conformity and Compliance with International Standards on Auditing

21. As of July 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 580, *Written Representations*. Compliance with the requirements of this HKSA ensures compliance with ISA 580.

22. Additional local explanation is provided in footnote 1a and additional local guidance is provided in footnote 2a and 3a of Appendix 2.

***

Application and Other Explanatory Material

Written Representations as Audit Evidence (Ref: Para. 3)

A1. Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Management from whom Written Representations Requested (Ref: Para. 9)

A2. Written representations are requested from those responsible for the preparation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation of the financial statements.

A3. Due to its responsibility for the preparation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing the financial statements and the assertions therein on which to base the written representations.

A4. In some cases, however, management may decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein, including individuals who have specialized knowledge relating to the matters about which written representations are requested. Such individuals may include:

- An actuary responsible for actuarially determined accounting measurements.
- Staff engineers who may have responsibility for and specialized knowledge about environmental liability measurements.
- Internal counsel who may provide information essential to provisions for legal claims.

A5. In some cases, management may include in the written representations qualifying language to the effect that representations are made to the best of its knowledge and belief. It is reasonable for the auditor to accept such wording if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.

A6. To reinforce the need for management to make informed representations, the auditor may request that management include in the written representations confirmation that it has made such inquiries as it considered appropriate to place it in the position to be able to make the requested written representations. It is not expected that such inquiries would usually require a formal internal process beyond those already established by the entity.

Written Representations about Management's Responsibilities (Ref: Para. 10-11)

A7. Audit evidence obtained during the audit that management has fulfilled the responsibilities referred to in paragraphs 10 and 11 is not sufficient without obtaining confirmation from management that it believes that it has fulfilled those responsibilities. This is because the auditor is not able to judge solely on other audit evidence whether management has prepared and presented the financial statements and provided information to the auditor on the basis of the agreed acknowledgement and understanding of its responsibilities. For example, the auditor could not conclude that management has provided the auditor with all relevant information agreed in the terms of the audit engagement without asking it whether, and receiving confirmation that, such information has been provided.

A8. The written representations required by paragraphs 10 and 11 draw on the agreed acknowledgement and understanding of management of its responsibilities in the terms of the audit engagement by requesting confirmation that it has fulfilled them. The auditor may also ask management to reconfirm its acknowledgement and understanding of those responsibilities in written representations. This is common in certain jurisdictions, but in any event may be particularly appropriate when:

- Those who signed the terms of the audit engagement on behalf of the entity no longer have the relevant responsibilities;
- The terms of the audit engagement were prepared in a previous year;
- There is any indication that management misunderstands those responsibilities; or
- Changes in circumstances make it appropriate to do so.

Consistent with the requirement of HKSA 210,[5] such reconfirmation of management's acknowledgement and understanding of its responsibilities is not made subject to the best of management's knowledge and belief (as discussed in paragraph A5 of this HKSA).

[5] HKSA 210, paragraph 6(b)

Considerations Specific to Public Sector Entities

A9. The mandates for audits of the financial statements of public sector entities may be broader than those of other entities. As a result, the premise, relating to management's responsibilities, on which an audit of the financial statements of a public sector entity is conducted may give rise to additional written representations. These may include written representations confirming that transactions and events have been carried out in accordance with law, regulation or other authority.

Other Written Representations (Ref: Para. 13)

Additional Written Representations about the Financial Statements

A10. In addition to the written representation required by paragraph 10, the auditor may consider it necessary to request other written representations about the financial statements. Such written representations may supplement, but do not form part of, the written representation required by paragraph 10. They may include representations about the following:

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following, where relevant under the applicable financial reporting framework, have been recognized, measured, presented or disclosed in accordance with that framework:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities;
  - Liabilities, both actual and contingent;
  - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral; and
  - Aspects of laws, regulations and contractual agreements that may affect the financial statements, including non-compliance.

Additional Written Representations about Information Provided to the Auditor

A11. In addition to the written representation required by paragraph 11, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.

Written Representations about Specific Assertions

A12. When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action.
- The entity's ability to pursue a specific course of action.
- The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

A13. In addition, the auditor may consider it necessary to request management to provide written representations about specific assertions in the financial statements; in particular, to support an understanding that the auditor has obtained from other audit evidence of management's judgment or intent in relation to, or the completeness of, a specific assertion. For example, if the intent of management is important to the valuation basis for investments, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management about its intentions. Although such written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own for that assertion.

Communicating a Threshold Amount (Ref: Para. 10-11, 13)

A14. HKSA 450 requires the auditor to accumulate misstatements identified during the audit, other than those that are clearly trivial.[6] The auditor may determine a threshold above which misstatements cannot be regarded as clearly trivial. In the same way, the auditor may consider communicating to management a threshold for purposes of the requested written representations.

Date of and Period(s) Covered by Written Representations (Ref: Para. 14)

A15. Because written representations are necessary audit evidence, the auditor's opinion cannot be expressed, and the auditor's report cannot be dated, before the date of the written representations. Furthermore, because the auditor is concerned with events occurring up to the date of the auditor's report that may require adjustment to or disclosure in the financial statements, the written representations are dated as near as practicable to, but not after, the date of the auditor's report on the financial statements.

A16. In some circumstances, it may be appropriate for the auditor to obtain a written representation about a specific assertion in the financial statements during the course of the audit. Where this is the case, it may be necessary to request an updated written representation.

A17. The written representations are for all periods referred to in the auditor's report because management needs to reaffirm that the written representations it previously made with respect to the prior periods remain appropriate. The auditor and management may agree to a form of written representation that updates written representations relating to the prior periods by addressing whether there are any changes to such written representations and, if so, what they are.

A18. Situations may arise where current management were not present during all periods referred to in the auditor's report. Such persons may assert that they are not in a position to provide some or all of the written representations because they were not in place during the period. This fact, however, does not diminish such persons' responsibilities for the financial statements as a whole. Accordingly, the requirement for the auditor to request from them written representations that cover the whole of the relevant period(s) still applies.

Form of Written Representations (Ref: Para. 15)

A19. Written representations are required to be included in a representation letter addressed to the auditor. In some jurisdictions, however, management may be required by law or regulation to make a written public statement about its responsibilities. Although such statement is a representation to the users of the financial statements, or to relevant authorities, the auditor may determine that it is an appropriate form of written representation in respect of some or all of the representations required by paragraph 10 or 11. Consequently, the relevant matters covered by such statement need not be included in the representation letter. Factors that may affect the auditor's determination include:

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[6] HKSA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 5

- Whether the statement includes confirmation of the fulfillment of the responsibilities referred to in paragraphs 10 and 11.
- Whether the statement has been given or approved by those from whom the auditor requests the relevant written representations.
- Whether a copy of the statement is provided to the auditor as near as practicable to, but not after, the date of the auditor's report on the financial statements (see paragraph 14).

A20. A formal statement of compliance with law or regulation, or of approval of the financial statements, would not contain sufficient information for the auditor to be satisfied that all necessary representations have been consciously made. The expression of management's responsibilities in law or regulation is also not a substitute for the requested written representations.

A21. Appendix 2 provides an illustrative example of a representation letter.

Communication with Those Charged with Governance (Ref: Para. 10-11, 13)

A22. HKSA 260 (Revised) requires the auditor to communicate with those charged with governance the written representations which the auditor has requested from management.[7]

Doubt as to the Reliability of Written Representations and Requested Written Representations Not Provided

Doubt as to the Reliability of Written Representations (Ref: Para. 16-17)

A23. In the case of identified inconsistencies between one or more written representations and audit evidence obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

A24. Concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, may cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted. In such a case, the auditor may consider withdrawing from the engagement, where withdrawal is possible under applicable law or regulation, unless those charged with governance put in place appropriate corrective measures. Such measures, however, may not be sufficient to enable the auditor to issue an unmodified audit opinion.

A25. HKSA 230 requires the auditor to document significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.[8] The auditor may have identified significant issues relating to the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, but concluded that the written representations are nevertheless reliable. In such a case, this significant matter is documented in accordance with HKSA 230.

Written Representations about Management's Responsibilities (Ref: Para. 20)

A26. As explained in paragraph A7, the auditor is not able to judge solely on other audit evidence whether management has fulfilled the responsibilities referred to in paragraphs 10 and 11. Therefore, if, as described in paragraph 20(a), the auditor concludes that the written representations about these matters are unreliable, or if management does not provide those written representations, the auditor is unable to obtain sufficient appropriate audit evidence.

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7 HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16(c)(ii)

8 HKSA 230, *Audit Documentation*, paragraphs 8(c) and 10

The possible effects on the financial statements of such inability are not confined to specific elements, accounts or items of the financial statements and are hence pervasive. HKSA 705 (Revised) requires the auditor to disclaim an opinion on the financial statements in such circumstances.[9]

A27. A written representation that has been modified from that requested by the auditor does not necessarily mean that management did not provide the written representation. However, the underlying reason for such modification may affect the opinion in the auditor's report. For example:

- The written representation about management's fulfillment of its responsibility for the preparation of the financial statements may state that management believes that, except for material non-compliance with a particular requirement of the applicable financial reporting framework, the financial statements are prepared in accordance with that framework. The requirement in paragraph 20 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effect of the non-compliance on the opinion in the auditor's report in accordance with HKSA 705 (Revised).

- The written representation about the responsibility of management to provide the auditor with all relevant information agreed in the terms of the audit engagement may state that management believes that, except for information destroyed in a fire, it has provided the auditor with such information. The requirement in paragraph 20 does not apply because the auditor concluded that management has provided reliable written representations. However, the auditor is required to consider the effects of the pervasiveness of the information destroyed in the fire on the financial statements and the effect thereof on the opinion in the auditor's report in accordance with HKSA 705 (Revised).

[9] HKSA 705 (Revised), paragraph 9

Appendix 1

(Ref: Para. 2)

List of HKSAs Containing Requirements for Written Representations

This appendix identifies paragraphs in other HKSAs that require subject-matter specific written representations. The list is not a substitute for considering the requirements and related application and other explanatory material in HKSAs.

- HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraph 39
- HKSA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 16
- HKSA 450, *Evaluation of Misstatements Identified during the Audit* – paragraph 14
- HKSA 501, *Audit Evidence—Specific Considerations for Selected Items* – paragraph 12
- HKSA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* – paragraph 22
- HKSA 550, *Related Parties* – paragraph 26
- HKSA 560, *Subsequent Events* – paragraph 9
- HKSA 570 (Revised), *Going Concern* – paragraph 16(e)
- HKSA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraph 9
- HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* – paragraph 13(c)

Appendix 2

(Ref: Para. A21)

Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other HKSAs. It is assumed in this illustration that the applicable financial reporting framework is Hong Kong Financial Reporting Standards; the requirement of HKSA 570 (Revised) [1] to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended 31 December 20XX [2] for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with Hong Kong Financial Reporting Standards.

We confirm that (*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):[2a]

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with Hong Kong Financial Reporting Standards; in particular the financial statements are fairly presented (or *give a true and fair view*) in accordance therewith.

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1 HKSA 570 (Revised), *Going Concern*

2 Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

2a The following additional management representations are applicable to audits of companies incorporated under the Companies Ordinance:

- We acknowledge that section 380 of the Companies Ordinance requires us to prepare financial statements which give a true and fair view of the financial position of the company as at the end of the financial year and of the financial performance of the company for the financial year.
- We are responsible for taking all reasonable steps to ensure the company keeps proper accounting records which are sufficient to show and explain the company's transactions, disclose with reasonable accuracy at any time the company's financial position and financial performance and to ensure that the financial statements comply with the Companies Ordinance.
- The financial statements comply with section 383 (Notes to Financial Statements to Contain Information on Directors' Emoluments etc) of the Companies Ordinance which must contain in the notes to the financial statements, the information prescribed by the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G).
- We are responsible for the preparation of the director's report that
  - (a) complies with sections 390 (Contents of Directors' Report: General) and 543(2) (Disclosure of Management Contract) and Schedule 5 (Contents of Directors' Report: Business Review) of the Companies Ordinance;
  - (b) contains the information prescribed by the regulations made under section 452(3) (Financial Secretary May Make Other Regulations) of the Companies Ordinance; and
  - (c) complies with other requirements prescribed by the regulations made under section 452 (3) of the Companies Ordinance.

- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (HKSA 540)

- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of Hong Kong Financial Reporting Standards. (HKSA 550)

- All events subsequent to the date of the financial statements and for which Hong Kong Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed. (HKSA 560)

- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (HKSA 450)

- [Any other matters that the auditor may consider appropriate (see paragraph A10 of this HKSA).]

Information Provided

- We have provided you with: [3]

  - Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as records, documentation and other matters;

  - Additional information that you have requested from us for the purpose of the audit; and

  - Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

- All transactions have been recorded in the accounting records and are reflected in the financial statements.

- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (HKSA 240)

- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:

  - Management;

  - Employees who have significant roles in internal control; or

  - Others where the fraud could have a material effect on the financial statements. (HKSA 240)

- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (HKSA 240)

- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (HKSA 250)

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[3] If the auditor has included other matters relating to management's responsibilities in the audit engagement letter in accordance with HKSA 210, *Agreeing the Terms of Audit Engagements*, consideration may be given to including these matters in the written representations from management or those charged with governance.

- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (HKSA 550)

- [Any other matters that the auditor may consider necessary (see paragraph A11 of this HKSA).][3a]

Management	Management

[3a] If the auditor has included management's responsibilities for other information in the audit engagement letter in accordance with HKSA 210, consideration may be given to include these in the written representations from management or those charged with governance:

Other Information

- In addition to the (consolidated)* financial statements, we are responsible for the preparation of other information included in the annual report. We have informed you of all the documents that we expect to issue that may comprise other information.
- We confirm that the other information comprises [X documents - input specific description of the other information]] which we provided to you prior to or as of [input the date of your auditor's report], [and the [Y documents - input specific description of the other information not obtained as of auditor's report date] which is/are expected to be made available to you by [input the expected timing of issuance].]
- We confirm that the (consolidated)* financial statements and any other information provided to you are consistent with one another, and the other information does not contain any material misstatements.

HKSA 600
Issued September 2009; revised July 2010, May 2013,
June 2014, February 2015, August 2015, June 2017

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

Hong Kong Standard on Auditing 600

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

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

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HONG KONG STANDARD ON AUDITING 600

SPECIAL CONSIDERATIONS—AUDITS OF GROUP FINANCIAL STATEMENTS (Including the Work of Component Auditors)

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

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Hong Kong Standard on Auditing (HKSA) 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. The Hong Kong Standards on Auditing (HKSAs) apply to group audits. This HKSA deals with special considerations that apply to group audits, in particular those that involve component auditors.

2. An auditor may find this HKSA, adapted as necessary in the circumstances, useful when that auditor involves other auditors in the audit of financial statements that are not group financial statements. For example, an auditor may involve another auditor to observe the inventory count or inspect physical fixed assets at a remote location.

3. A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of a component. The group engagement team may decide to use the audit evidence on which the audit opinion on the financial statements of the component is based to provide audit evidence for the group audit, but the requirements of this HKSA nevertheless apply. (Ref: Para. A1)

4. In accordance with HKSA 220,[1] the group engagement partner is required to be satisfied that those performing the group audit engagement, including component auditors, collectively have the appropriate competence and capabilities. The group engagement partner is also responsible for the direction, supervision and performance of the group audit engagement.

5. The group engagement partner applies the requirements of HKSA 220 regardless of whether the group engagement team or a component auditor performs the work on the financial information of a component. This HKSA assists the group engagement partner to meet the requirements of HKSA 220 where component auditors perform work on the financial information of components.

6. Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatements.[2] In a group audit, this includes the risk that the component auditor may not detect a misstatement in the financial information of the component that could cause a material misstatement of the group financial statements, and the risk that the group engagement team may not detect this misstatement. This HKSA explains the matters that the group engagement team considers when determining the nature, timing and extent of its involvement in the risk assessment procedures and further audit procedures performed by the component auditors on the financial information of the components. The purpose of this involvement is to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.

Effective Date

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

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[1] HKSA 220, *Quality Control for an Audit of Financial Statements*, paragraphs 14 - 15

[2] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph A34

Objectives

8. The objectives of the auditor are:

   (a) To determine whether to act as the auditor of the group financial statements; and

   (b) If acting as the auditor of the group financial statements:

      (i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings; and

      (ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Definitions

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

   (a) Component – An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements. (Ref: Para. A2-A4)

   (b) Component auditor – An auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit. (Ref: Para. A7)

   (c) Component management – Management responsible for the preparation of the financial information of a component.

   (d) Component materiality – The materiality for a component determined by the group engagement team.

   (e) Group – All the components whose financial information is included in the group financial statements. A group always has more than one component.

   (f) Group audit – The audit of group financial statements.

   (g) Group audit opinion – The audit opinion on the group financial statements.

   (h) Group engagement partner – The partner or other person in the firm who is responsible for the group audit engagement and its performance, and for the auditor's report on the group financial statements that is issued on behalf of the firm. Where joint auditors conduct the group audit, the joint engagement partners and their engagement teams collectively constitute the group engagement partner and the group engagement team. This HKSA does not, however, deal with the relationship between joint auditors or the work that one joint auditor performs in relation to the work of the other joint auditor.

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

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

(k) Group management – Management responsible for the preparation of the group financial statements.

(l) Group-wide controls – Controls designed, implemented and maintained by group management over group financial reporting.

(m) Significant component – A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements. (Ref: Para. A5-A6)

10. Reference to "the applicable financial reporting framework" means the financial reporting framework that applies to the group financial statements. Reference to "the consolidation process" includes:

(a) The recognition, measurement, presentation, and disclosure of the financial information of the components in the group financial statements by way of consolidation, proportionate consolidation, or the equity or cost methods of accounting; and

(b) The aggregation in combined financial statements of the financial information of components that have no parent but are under common control.

Requirements

Responsibility

11. The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and applicable legal and regulatory requirements, and whether the auditor's report that is issued is appropriate in the circumstances.[3] As a result, the auditor's report on the group financial statements shall not refer to a component auditor, unless required by law or regulation to include such reference. If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group engagement partner's or the group engagement partner's firm's responsibility for the group audit opinion. (Ref: Para. A8-A9)

Acceptance and Continuance

12. In applying HKSA 220, the group engagement partner shall determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained in relation to the consolidation process and the financial information of the components on which to base the group audit opinion. For this purpose, the group engagement team shall obtain an understanding of the group, its components, and their environments that is sufficient to identify components that are likely to be significant components. Where component auditors will perform work on the financial information of such components, the group engagement partner shall evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence. (Ref: Para. A10-A12)

[3] HKSA 220, paragraph 15

13. If the group engagement partner concludes that:

    (a) it will not be possible for the group engagement team to obtain sufficient appropriate audit evidence due to restrictions imposed by group management; and

    (b) the possible effect of this inability will result in a disclaimer of opinion on the group financial statements,[4]

    the group engagement partner shall either:

    (a) in the case of a new engagement, not accept the engagement, or, in the case of a continuing engagement, withdraw from the engagement, where withdrawal is possible under applicable law or regulation; or

    (b) where law or regulation prohibits an auditor from declining an engagement or where withdrawal from an engagement is not otherwise possible, having performed the audit of the group financial statements to the extent possible, disclaim an opinion on the group financial statements. (Ref: Para. A13-A19)

Terms of Engagement

14. The group engagement partner shall agree on the terms of the group audit engagement in accordance with HKSA 210.[5] (Ref: Para. A20-A21)

Overall Audit Strategy and Audit Plan

15. The group engagement team shall establish an overall group audit strategy and shall develop a group audit plan in accordance with HKSA 300.[6]

16. The group engagement partner shall review the overall group audit strategy and group audit plan. (Ref: Para. A22)

Understanding the Group, Its Components, and Their Environments

17. The auditor is required to identify and assess the risks of material misstatement through obtaining an understanding of the entity and its environment.[7] The group engagement team shall:

    (a) Enhance its understanding of the group, its components, and their environments, including group-wide controls, obtained during the acceptance or continuance stage; and

    (b) Obtain an understanding of the consolidation process, including the instructions issued by group management to components. (Ref: Para. A23-A29)

18. The group engagement team shall obtain an understanding that is sufficient to:

    (a) Confirm or revise its initial identification of components that are likely to be significant; and

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4 HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

5 HKSA 210, *Agreeing the Terms of Audit Engagements*

6 HKSA 300, *Planning an Audit of Financial Statements*, paragraphs 7-12

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

(b) Assess the risks of material misstatement of the group financial statements, whether due to fraud or error.[8] (Ref: Para. A30-A31)

Understanding the Component Auditor

19. If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following: (Ref: Para. A32-A35)

(a) Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent. (Ref: Para. A37)

(b) The component auditor's professional competence. (Ref: Para. A38)

(c) Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.

(d) Whether the component auditor operates in a regulatory environment that actively oversees auditors. (Ref: Para. A36)

20. If a component auditor does not meet the independence requirements that are relevant to the group audit, or the group engagement team has serious concerns about the other matters listed in paragraph 19(a)-(c), the group engagement team shall obtain sufficient appropriate audit evidence relating to the financial information of the component without requesting that component auditor to perform work on the financial information of that component. (Ref: Para. A39-A41)

Materiality

21. The group engagement team shall determine the following: (Ref: Para. A42)

(a) Materiality for the group financial statements as a whole when establishing the overall group audit strategy.

(b) If, in the specific circumstances of the group, there are particular classes of transactions, account balances or disclosures in the group financial statements for which misstatements of lesser amounts than materiality for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the group financial statements, the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures.

(c) Component materiality for those components where component auditors will perform an audit or a review for purposes of the group audit. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality shall be lower than materiality for the group financial statements as a whole. (Ref: Para. A43-A44)

(d) The threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements. (Ref: Para. A45)

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8 HKSA 315 (Revised)

22. Where component auditors will perform an audit for purposes of the group audit, the group engagement team shall evaluate the appropriateness of performance materiality determined at the component level. (Ref: Para. A46)

23. If a component is subject to audit by statute, regulation or other reason, and the group engagement team decides to use that audit to provide audit evidence for the group audit, the group engagement team shall determine whether:

    (a) materiality for the component financial statements as a whole; and

    (b) performance materiality at the component level

    meet the requirements of this HKSA.

Responding to Assessed Risks

24. The auditor is required to design and implement appropriate responses to address the assessed risks of material misstatement of the financial statements.[9] The group engagement team shall determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the financial information of the components (see paragraphs 26-29). The group engagement team shall also determine the nature, timing and extent of its involvement in the work of the component auditors (see paragraphs 30-31).

25. If the nature, timing and extent of the work to be performed on the consolidation process or the financial information of the components are based on an expectation that group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the group engagement team shall test, or request a component auditor to test, the operating effectiveness of those controls.

Determining the Type of Work to Be Performed on the Financial Information of Components (Ref: Para. A47)

Significant Components

26. For a component that is significant due to its individual financial significance to the group, the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using component materiality.

27. For a component that is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, shall perform one or more of the following:

    (a) An audit of the financial information of the component using component materiality.

    (b) An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements. (Ref: Para. A48)

    (c) Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements. (Ref: Para. A49)

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

Components that Are Not Significant Components

28. For components that are not significant components, the group engagement team shall perform analytical procedures at group level. (Ref: Para. A50)

29. If the group engagement team does not consider that sufficient appropriate audit evidence on which to base the group audit opinion will be obtained from:

(a) the work performed on the financial information of significant components;

(b) the work performed on group-wide controls and the consolidation process; and

(c) the analytical procedures performed at group level,

the group engagement team shall select components that are not significant components and shall perform, or request a component auditor to perform, one or more of the following on the financial information of the individual components selected: (Ref: Para. A51-A53)

- An audit of the financial information of the component using component materiality.
- An audit of one or more account balances, classes of transactions or disclosures.
- A review of the financial information of the component using component materiality.
- Specified procedures.

The group engagement team shall vary the selection of components over a period of time.

Involvement in the Work Performed by Component Auditors (Ref: Para. A54-A55)

Significant Components—Risk Assessment

30. If a component auditor performs an audit of the financial information of a significant component, the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements. The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but at a minimum shall include:

(a) Discussing with the component auditor or component management those of the component's business activities that are significant to the group;

(b) Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error; and

(c) Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.

Identified Significant Risks of Material Misstatement of the Group Financial Statements—Further Audit Procedures

31. If significant risks of material misstatement of the group financial statements have been identified in a component on which a component auditor performs the work, the group engagement team shall evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the group financial statements. Based on its understanding of the component auditor, the group

engagement team shall determine whether it is necessary to be involved in the further audit procedures.

Consolidation Process

32. In accordance with paragraph 17, the group engagement team obtains an understanding of group-wide controls and the consolidation process, including the instructions issued by group management to components. In accordance with paragraph 25, the group engagement team, or component auditor at the request of the group engagement team, tests the operating effectiveness of group-wide controls if the nature, timing and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

33. The group engagement team shall design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process. This shall include evaluating whether all components have been included in the group financial statements.

34. The group engagement team shall evaluate the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications, and shall evaluate whether any fraud risk factors or indicators of possible management bias exist. (Ref: Para. A56)

35. If the financial information of a component has not been prepared in accordance with the same accounting policies applied to the group financial statements, the group engagement team shall evaluate whether the financial information of that component has been appropriately adjusted for purposes of preparing and presenting the group financial statements.

36. The group engagement team shall determine whether the financial information identified in the component auditor's communication (see paragraph 41(c)) is the financial information that is incorporated in the group financial statements.

37. If the group financial statements include the financial statements of a component with a financial reporting period-end that differs from that of the group, the group engagement team shall evaluate whether appropriate adjustments have been made to those financial statements in accordance with the applicable financial reporting framework.

Subsequent Events

38. Where the group engagement team or component auditors perform audits on the financial information of components, the group engagement team or the component auditors shall perform procedures designed to identify events at those components that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements, and that may require adjustment to or disclosure in the group financial statements.

39. Where component auditors perform work other than audits of the financial information of components, the group engagement team shall request the component auditors to notify the group engagement team if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements.

Communication with the Component Auditor

40. The group engagement team shall communicate its requirements to the component auditor on a timely basis. This communication shall set out the work to be performed, the use to be made of that work, and the form and content of the component auditor's communication with the group engagement team. It shall also include the following: (Ref: Para. A57, A58, A60)

(a) A request that the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, confirms that the component auditor will cooperate with the group engagement team. (Ref: Para. A59)

(b) The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.

(c) In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

(d) Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor. The group engagement team shall request the component auditor to communicate on a timely basis any other identified significant risks of material misstatement of the group financial statements, due to fraud or error, in the component, and the component auditor's responses to such risks.

(e) A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware. The group engagement team shall request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team. The group engagement team shall determine whether to identify such additional related parties to other component auditors.

41. The group engagement team shall request the component auditor to communicate matters relevant to the group engagement team's conclusion with regard to the group audit. Such communication shall include: (Ref: Para. A60)

(a) Whether the component auditor has complied with ethical requirements that are relevant to the group audit, including independence and professional competence;

(b) Whether the component auditor has complied with the group engagement team's requirements;

(c) Identification of the financial information of the component on which the component auditor is reporting;

(d) Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements;

(e) A list of uncorrected misstatements of the financial information of the component (the list need not include misstatements that are below the threshold for clearly trivial misstatements communicated by the group engagement team (see paragraph 40(c));

(f) Indicators of possible management bias;

(g) Description of any identified significant deficiencies in internal control at the component level;

(h) Other significant matters that the component auditor communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component;

(i) Any other matters that may be relevant to the group audit, or that the component auditor wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from component management; and

(j) The component auditor's overall findings, conclusions or opinion.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Evaluating the Component Auditor's Communication and Adequacy of their Work

42. The group engagement team shall evaluate the component auditor's communication (see paragraph 41). The group engagement team shall:

(a) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate; and

(b) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation. (Ref: Para. A61)

43. If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

Sufficiency and Appropriateness of Audit Evidence

44. The auditor is required to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.[10] The group engagement team shall evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components, on which to base the group audit opinion. (Ref: Para. A62)

45. The group engagement partner shall evaluate the effect on the group audit opinion of any uncorrected misstatements (either identified by the group engagement team or communicated by component auditors) and any instances where there has been an inability to obtain sufficient appropriate audit evidence. (Ref: Para. A63)

Communication with Group Management and Those Charged with Governance of the Group

Communication with Group Management

46. The group engagement team shall determine which identified deficiencies in internal control to communicate to those charged with governance and group management in accordance with HKSA 265.[11] In making this determination, the group engagement team shall consider:

(a) Deficiencies in group-wide internal control that the group engagement team has identified;

(b) Deficiencies in internal control that the group engagement team has identified in internal controls at components; and

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[10] HKSA 200, paragraph 17

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

(c) Deficiencies in internal control that component auditors have brought to the attention of the group engagement team.

47. If fraud has been identified by the group engagement team or brought to its attention by a component auditor (see paragraph 41(h)), or information indicates that a fraud may exist, the group engagement team shall communicate this on a timely basis to the appropriate level of group management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. (Ref. Para. A64)

48. A component auditor may be required by statute, regulation or for another reason, to express an audit opinion on the financial statements of a component. In that case, the group engagement team shall request group management to inform component management of any matter of which the group engagement team becomes aware that may be significant to the financial statements of the component, but of which component management may be unaware. If group management refuses to communicate the matter to component management, the group engagement team shall discuss the matter with those charged with governance of the group. If the matter remains unresolved, the group engagement team, subject to legal and professional confidentiality considerations, shall consider whether to advise the component auditor not to issue the auditor's report on the financial statements of the component until the matter is resolved. (Ref: Para. A65)

Communication with Those Charged with Governance of the Group

49. The group engagement team shall communicate the following matters with those charged with governance of the group, in addition to those required by HKSA 260 (Revised) [12] and other HKSAs: (Ref: Para. A66)

(a) An overview of the type of work to be performed on the financial information of the components.

(b) An overview of the nature of the group engagement team's planned involvement in the work to be performed by the component auditors on the financial information of significant components.

(c) Instances where the group engagement team's evaluation of the work of a component auditor gave rise to a concern about the quality of that auditor's work.

(d) Any limitations on the group audit, for example, where the group engagement team's access to information may have been restricted.

(e) Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement of the group financial statements.

Documentation

50. The group engagement team shall include in the audit documentation the following matters:[13]

(a) An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components.

[12] HKSA 260 (Revised), *Communication with Those Charged with Governance*

[13] HKSA 230, *Audit Documentation*, paragraphs 8-11, and A6

(b) The nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components including, where applicable, the group engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon.

(c) Written communications between the group engagement team and the component auditors about the group engagement team's requirements.

Conformity and Compliance with International Standards on Auditing

51. As of September 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*. Compliance with the requirements of this HKSA ensures compliance with ISA 600.

52. Additional local explanation is provided in footnote 23a, Appendices 1 and 6.

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Application and Other Explanatory Material

Components Subject to Audit by Statute, Regulation or Other Reason (Ref: Para. 3)

A1. Factors that may affect the group engagement team's decision whether to use an audit required by statute, regulation or for another reason to provide audit evidence for the group audit include the following:

- Differences in the financial reporting framework applied in preparing the financial statements of the component and that applied in preparing the group financial statements.
- Differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements.
- Whether the audit of the financial statements of the component will be completed in time to meet the group reporting timetable.

Definitions

Component (Ref: Para. 9(a))

A2. The structure of a group affects how components are identified. For example, the group financial reporting system may be based on an organizational structure that provides for financial information to be prepared by a parent and one or more subsidiaries, joint ventures, or investees accounted for by the equity or cost methods of accounting; by a head office and one or more divisions or branches; or by a combination of both. Some groups, however, may organize their financial reporting system by function, process, product or service (or by groups of products or services), or geographic locations. In these cases, the entity or business activity for which group or component management prepares financial information that is included in the group financial statements may be a function, process, product or service (or group of products or services), or geographic location.

A3. Various levels of components may exist within the group financial reporting system, in which case it may be more appropriate to identify components at certain levels of aggregation rather than individually.

A4. Components aggregated at a certain level may constitute a component for purposes of the group audit; however, such a component may also prepare group financial statements that incorporate the financial information of the components it encompasses (that is, a subgroup). This HKSA may therefore be applied by different group engagement partners and teams for different subgroups within a larger group.

Significant Component (Ref: Para. 9(m))

A5. As the individual financial significance of a component increases, the risks of material misstatement of the group financial statements ordinarily increase. The group engagement team may apply a percentage to a chosen benchmark as an aid to identify components that are of individual financial significance. Identifying a benchmark and determining a percentage to be applied to it involve the exercise of professional judgment. Depending on the nature and circumstances of the group, appropriate benchmarks might include group assets, liabilities, cash flows, profit or turnover. For example, the group engagement team may consider that components exceeding 15% of the chosen benchmark are significant components. A higher or lower percentage may, however, be deemed appropriate in the circumstances.

A6. The group engagement team may also identify a component as likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances (that is, risks that require special audit consideration[14]). For example, a component could be responsible for foreign exchange trading and thus expose the group to a significant risk of material misstatement, even though the component is not otherwise of individual financial significance to the group.

Component Auditor (Ref: Para. 9(b))

A7. A member of the group engagement team may perform work on the financial information of a component for the group audit at the request of the group engagement team. Where this is the case, such a member of the engagement team is also a component auditor.

Responsibility (Ref: Para. 11)

A8. Although component auditors may perform work on the financial information of the components for the group audit and as such are responsible for their overall findings, conclusions or opinions, the group engagement partner or the group engagement partner's firm is responsible for the group audit opinion.

A9. When the group audit opinion is modified because the group engagement team was unable to obtain sufficient appropriate audit evidence in relation to the financial information of one or more components, the Basis for Modification paragraph in the auditor's report on the group financial statements describes the reasons for that inability without referring to the component auditor, unless such a reference is necessary for an adequate explanation of the circumstances.[15]

Acceptance and Continuance

Obtaining an Understanding at the Acceptance or Continuance Stage (Ref: Para. 12)

A10. In the case of a new engagement, the group engagement team's understanding of the group, its components, and their environments may be obtained from:

- Information provided by group management;

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[14] HKSA 315 (Revised), paragraphs 27-29

[15] HKSA 705 (Revised), paragraph 20

- Communication with group management; and
- Where applicable, communication with the previous group engagement team, component management, or component auditors.

A11. The group engagement team's understanding may include matters such as the following:

- The group structure, including both the legal and organizational structure (that is, how the group financial reporting system is organized).
- Components' business activities that are significant to the group, including the industry and regulatory, economic and political environments in which those activities take place.
- The use of service organizations, including shared service centers.
- A description of group-wide controls.
- The complexity of the consolidation process.
- Whether component auditors that are not from the group engagement partner's firm or network will perform work on the financial information of any of the components, and group management's rationale for appointing more than one auditor.
- Whether the group engagement team:
    - Will have unrestricted access to those charged with governance of the group, group management, those charged with governance of the component, component management, component information, and the component auditors (including relevant audit documentation sought by the group engagement team); and
    - Will be able to perform necessary work on the financial information of the components.

A12. In the case of a continuing engagement, the group engagement team's ability to obtain sufficient appropriate audit evidence may be affected by significant changes, for example:

- Changes in the group structure (for example, acquisitions, disposals, reorganizations, or changes in how the group financial reporting system is organized).
- Changes in components' business activities that are significant to the group.
- Changes in the composition of those charged with governance of the group, group management, or key management of significant components.
- Concerns the group engagement team has with regard to the integrity and competence of group or component management.
- Changes in group-wide controls.
- Changes in the applicable financial reporting framework.

Expectation to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 13)

A13. A group may consist only of components not considered significant components. In these circumstances, the group engagement partner can reasonably expect to obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team will be able to:

(a) Perform the work on the financial information of some of these components; and

(b) Be involved in the work performed by component auditors on the financial information of other components to the extent necessary to obtain sufficient appropriate audit evidence.

Access to Information (Ref: Para. 13)

A14. The group engagement team's access to information may be restricted by circumstances that cannot be overcome by group management, for example laws relating to confidentiality and data privacy, or denial by the component auditor of access to relevant audit documentation sought by the group engagement team. It may also be restricted by group management.

A15. Where access to information is restricted by circumstances, the group engagement team may still be able to obtain sufficient appropriate audit evidence; however, this is less likely as the significance of the component increases. For example, the group engagement team may not have access to those charged with governance, management, or the auditor (including relevant audit documentation sought by the group engagement team) of a component that is accounted for by the equity method of accounting. If the component is not a significant component, and the group engagement team has a complete set of financial statements of the component, including the auditor's report thereon, and has access to information kept by group management in relation to that component, the group engagement team may conclude that this information constitutes sufficient appropriate audit evidence in relation to that component. If the component is a significant component, however, the group engagement team will not be able to comply with the requirements of this HKSA relevant in the circumstances of the group audit. For example, the group engagement team will not be able to comply with the requirement in paragraphs 30-31 to be involved in the work of the component auditor. The group engagement team will not, therefore, be able to obtain sufficient appropriate audit evidence in relation to that component. The effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of HKSA 705 (Revised).

A16. The group engagement team will not be able to obtain sufficient appropriate audit evidence if group management restricts the access of the group engagement team or a component auditor to the information of a significant component.

A17. Although the group engagement team may be able to obtain sufficient appropriate audit evidence if such restriction relates to a component considered not a significant component, the reason for the restriction may affect the group audit opinion. For example, it may affect the reliability of group management's responses to the group engagement team's inquiries and group management's representations to the group engagement team.

A18. Law or regulation may prohibit the group engagement partner from declining or withdrawing from an engagement. For example, in some jurisdictions the auditor is appointed for a specified period of time and is prohibited from withdrawing before the end of that period. Also, in the public sector, the option of declining or withdrawing from an engagement may not be available to the auditor due to the nature of the mandate or public interest considerations. In these circumstances, this HKSA still applies to the group audit, and the effect of the group engagement team's inability to obtain sufficient appropriate audit evidence is considered in terms of HKSA 705 (Revised).

A19. Appendix 1 contains an example of an auditor's report containing a qualified opinion based on the group engagement team's inability to obtain sufficient appropriate audit evidence in relation to a significant component accounted for by the equity method of accounting, but where, in the group engagement team's judgment, the effect is material but not pervasive.

Terms of Engagement (Ref: Para. 14)

A20. The terms of engagement identify the applicable financial reporting framework.[16] Additional matters may be included in the terms of a group audit engagement, such as the fact that:

- The communication between the group engagement team and the component auditors should be unrestricted to the extent possible under law or regulation;
- Important communications between the component auditors, those charged with governance of the component, and component management, including communications on significant deficiencies in internal control, should be communicated as well to the group engagement team;
- Important communications between regulatory authorities and components related to financial reporting matters should be communicated to the group engagement team; and
- To the extent the group engagement team considers necessary, it should be permitted:
    - o Access to component information, those charged with governance of components, component management, and the component auditors (including relevant audit documentation sought by the group engagement team); and
    - o To perform work or request a component auditor to perform work on the financial information of the components.

A21. Restrictions imposed on:

- the group engagement team's access to component information, those charged with governance of components, component management, or the component auditors (including relevant audit documentation sought by the group engagement team); or
- the work to be performed on the financial information of the components,

after the group engagement partner's acceptance of the group audit engagement, constitute an inability to obtain sufficient appropriate audit evidence that may affect the group audit opinion. In exceptional circumstances it may even lead to withdrawal from the engagement where withdrawal is possible under applicable law or regulation.

Overall Audit Strategy and Audit Plan (Ref: Para. 16)

A22. The group engagement partner's review of the overall group audit strategy and group audit plan is an important part of fulfilling the group engagement partner's responsibility for the direction of the group audit engagement.

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16 HKSA 210, paragraph 8

Understanding the Group, Its Components, and Their Environments

Matters about Which the Group Engagement Team Obtains an Understanding (Ref: Para. 17)

A23. HKSA 315 (Revised) contains guidance on matters the auditor may consider when obtaining an understanding of the industry, regulatory, and other external factors that affect the entity, including the applicable financial reporting framework; the nature of the entity; objectives and strategies and related business risks; and measurement and review of the entity's financial performance.[17] Appendix 2 of this HKSA contains guidance on matters specific to a group, including the consolidation process.

Instructions Issued by Group Management to Components (Ref: Para. 17)

A24. To achieve uniformity and comparability of financial information, group management ordinarily issues instructions to components. Such instructions specify the requirements for financial information of the components to be included in the group financial statements and often include financial reporting procedures manuals and a reporting package. A reporting package ordinarily consists of standard formats for providing financial information for incorporation in the group financial statements. Reporting packages generally do not, however, take the form of complete financial statements prepared and presented in accordance with the applicable financial reporting framework.

A25. The instructions ordinarily cover:

- The accounting policies to be applied;
- Statutory and other disclosure requirements applicable to the group financial statements, including:
    - The identification and reporting of segments;
    - Related party relationships and transactions;
    - Intra-group transactions and unrealized profits;
    - Intra-group account balances; and
- A reporting timetable.

A26. The group engagement team's understanding of the instructions may include the following:

- The clarity and practicality of the instructions for completing the reporting package.
- Whether the instructions:
    - Adequately describe the characteristics of the applicable financial reporting framework;
    - Provide for disclosures that are sufficient to comply with the requirements of the applicable financial reporting framework, for example, disclosure of related party relationships and transactions, and segment information;
    - Provide for the identification of consolidation adjustments, for example, intra-group transactions and unrealized profits, and intra-group account balances; and

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[17] HKSA 315 (Revised), paragraphs A25-A49.

- Provide for the approval of the financial information by component management.

Fraud (Ref: Para. 17)

A27. The auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud, and to design and implement appropriate responses to the assessed risks.[18] Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following:

- Group management's assessment of the risks that the group financial statements may be materially misstated as a result of fraud.
- Group management's process for identifying and responding to the risks of fraud in the group, including any specific fraud risks identified by group management, or account balances, classes of transactions, or disclosures for which a risk of fraud is likely.
- Whether there are particular components for which a risk of fraud is likely.
- How those charged with governance of the group monitor group management's processes for identifying and responding to the risks of fraud in the group, and the controls group management has established to mitigate these risks.
- Responses of those charged with governance of the group, group management, appropriate individuals within the internal audit function (and if considered appropriate, component management, the component auditors, and others) to the group engagement team's inquiry whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group.

Discussion among Group Engagement Team Members and Component Auditors Regarding the Risks of Material Misstatement of the Group Financial Statements, Including Risks of Fraud (Ref: Para. 17)

A28. The key members of the engagement team are required to discuss the susceptibility of an entity to material misstatement of the financial statements due to fraud or error, specifically emphasizing the risks due to fraud. In a group audit, these discussions may also include the component auditors.[19] The group engagement partner's determination of who to include in the discussions, how and when they occur, and their extent, is affected by factors such as prior experience with the group.

A29. The discussions provide an opportunity to:

- Share knowledge of the components and their environments, including group-wide controls.
- Exchange information about the business risks of the components or the group.
- Exchange ideas about how and where the group financial statements may be susceptible to material misstatement due to fraud or error, how group management and component management could perpetrate and conceal fraudulent financial reporting, and how assets of the components could be misappropriated.

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

[19] HKSA 240, paragraph 15; HKSA 315 (Revised), paragraph 10

- Identify practices followed by group or component management that may be biased or designed to manage earnings that could lead to fraudulent financial reporting, for example, revenue recognition practices that do not comply with the applicable financial reporting framework.

- Consider known external and internal factors affecting the group that may create an incentive or pressure for group management, component management, or others to commit fraud, provide the opportunity for fraud to be perpetrated, or indicate a culture or environment that enables group management, component management, or others to rationalize committing fraud.

- Consider the risk that group or component management may override controls.

- Consider whether uniform accounting policies are used to prepare the financial information of the components for the group financial statements and, where not, how differences in accounting policies are identified and adjusted (where required by the applicable financial reporting framework).

- Discuss fraud that has been identified in components, or information that indicates existence of a fraud in a component.

- Share information that may indicate non-compliance with national laws or regulations, for example, payments of bribes and improper transfer pricing practices.

Risk Factors (Ref: Para. 18)

A30. Appendix 3 sets out examples of conditions or events that, individually or together, may indicate risks of material misstatement of the group financial statements, including risks due to fraud.

Risk Assessment (Ref: Para. 18)

A31. The group engagement team's assessment at group level of the risks of material misstatement of the group financial statements is based on information such as the following:

- Information obtained from the understanding of the group, its components, and their environments, and of the consolidation process, including audit evidence obtained in evaluating the design and implementation of group-wide controls and controls that are relevant to the consolidation.

- Information obtained from the component auditors.

Understanding the Component Auditor (Ref: Para. 19)

A32. The group engagement team obtains an understanding of a component auditor only when it plans to request the component auditor to perform work on the financial information of a component for the group audit. For example, it will not be necessary to obtain an understanding of the auditors of those components for which the group engagement team plans to perform analytical procedures at group level only.

Group Engagement Team's Procedures to Obtain an Understanding of the Component Auditor and Sources of Audit Evidence (Ref: Para. 19)

A33. The nature, timing and extent of the group engagement team's procedures to obtain an understanding of the component auditor are affected by factors such as previous experience with or knowledge of the component auditor, and the degree to which the group engagement team and the component auditor are subject to common policies and procedures, for example:

- Whether the group engagement team and a component auditor share:
  - Common policies and procedures for performing the work (for example, audit methodologies);
  - Common quality control policies and procedures; or
  - Common monitoring policies and procedures.
- The consistency or similarity of:
  - Laws and regulations or legal system;
  - Professional oversight, discipline, and external quality assurance;
  - Education and training;
  - Professional organizations and standards; or
  - Language and culture.

A34. These factors interact and are not mutually exclusive. For example, the extent of the group engagement team's procedures to obtain an understanding of Component Auditor A, who consistently applies common quality control and monitoring policies and procedures and a common audit methodology or operates in the same jurisdiction as the group engagement partner, may be less than the extent of the group engagement team's procedures to obtain an understanding of Component Auditor B, who is not consistently applying common quality control and monitoring policies and procedures and a common audit methodology or operates in a foreign jurisdiction. The nature of the procedures performed in relation to Component Auditors A and B may also be different.

A35. The group engagement team may obtain an understanding of the component auditor in a number of ways. In the first year of involving a component auditor, the group engagement team may, for example:

- Evaluate the results of the quality control monitoring system where the group engagement team and component auditor are from a firm or network that operates under and complies with common monitoring policies and procedures;[20]
- Visit the component auditor to discuss the matters in paragraph 19(a)-(c);
- Request the component auditor to confirm the matters referred to in paragraph 19(a)-(c) in writing. Appendix 4 contains an example of written confirmations by a component auditor;
- Request the component auditor to complete questionnaires about the matters in paragraph 19(a)-(c);
- Discuss the component auditor with colleagues in the group engagement partner's firm, or with a reputable third party that has knowledge of the component auditor; or

[20] As required by Hong Kong Standard on Quality Control (HKSQC 1), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, paragraph 54, or national requirements that are at least as demanding.

- Obtain confirmations from the professional body or bodies to which the component auditor belongs, the authorities by which the component auditor is licensed, or other third parties.

In subsequent years, the understanding of the component auditor may be based on the group engagement team's previous experience with the component auditor. The group engagement team may request the component auditor to confirm whether anything in relation to the matters listed in paragraph 19(a)-(c) has changed since the previous year.

A36. Where independent oversight bodies have been established to oversee the auditing profession and monitor the quality of audits, awareness of the regulatory environment may assist the group engagement team in evaluating the independence and competence of the component auditor. Information about the regulatory environment may be obtained from the component auditor or information provided by the independent oversight bodies.

Ethical Requirements that Are Relevant to the Group Audit (Ref: Para. 19(a))

A37. When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements that are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing a statutory audit in the component auditor's jurisdiction. The group engagement team therefore obtains an understanding whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit, sufficient to fulfill the component auditor's responsibilities in the group audit.

The Component Auditor's Professional Competence (Ref: Para. 19(b))

A38. The group engagement team's understanding of the component auditor's professional competence may include whether the component auditor:

- Possesses an understanding of auditing and other standards applicable to the group audit that is sufficient to fulfill the component auditor's responsibilities in the group audit;

- Possesses the special skills (for example, industry specific knowledge) necessary to perform the work on the financial information of the particular component; and

- Where relevant, possesses an understanding of the applicable financial reporting framework that is sufficient to fulfill the component auditor's responsibilities in the group audit (instructions issued by group management to components often describe the characteristics of the applicable financial reporting framework).

Application of the Group Engagement Team's Understanding of a Component Auditor (Ref: Para. 20)

A39. The group engagement team cannot overcome the fact that a component auditor is not independent by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

A40. However, the group engagement team may be able to overcome less than serious concerns about the component auditor's professional competency (for example, lack of industry specific knowledge), or the fact that the component auditor does not operate in an environment that actively oversees auditors, by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component.

A41. Where law or regulation prohibits access to relevant parts of the audit documentation of the component auditor, the group engagement team may request the component auditor to overcome this by preparing a memorandum that covers the relevant information.

Materiality (Ref: Para. 21-23)

A42. The auditor is required:[21]

(a) When establishing the overall audit strategy, to determine:

(i) Materiality for the financial statements as a whole; and

(ii) If, in the specific circumstances of the entity, there are particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures; and

(b) To determine performance materiality.

In the context of a group audit, materiality is established for both the group financial statements as a whole, and for the financial information of the components. Materiality for the group financial statements as a whole is used when establishing the overall group audit strategy.

A43. To reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the group financial statements exceeds materiality for the group financial statements as a whole, component materiality is set lower than materiality for the group financial statements as a whole. Different component materiality may be established for different components. Component materiality need not be an arithmetical portion of the materiality for the group financial statements as a whole and, consequently, the aggregate of component materiality for the different components may exceed the materiality for the group financial statements as a whole. Component materiality is used when establishing the overall audit strategy for a component.

A44. Component materiality is determined for those components whose financial information will be audited or reviewed as part of the group audit in accordance with paragraphs 26, 27(a) and 29. Component materiality is used by the component auditor to evaluate whether uncorrected detected misstatements are material, individually or in the aggregate.

A45. A threshold for misstatements is determined in addition to component materiality. Misstatements identified in the financial information of the component that are above the threshold for misstatements are communicated to the group engagement team.

A46. In the case of an audit of the financial information of a component, the component auditor (or group engagement team) determines performance materiality at the component level. This is necessary to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial information of the component exceeds component materiality. In practice, the group engagement team may set component materiality at this lower level. Where this is the case, the component auditor uses component materiality for purposes of assessing the risks of material misstatement of the financial information of the component and to design further audit procedures in response to assessed risks as well as for evaluating whether detected misstatements are material individually or in the aggregate.

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[21] HKSA 320, *Materiality in Planning and Performing an Audit*, paragraphs 10-11

Responding to Assessed Risks

Determining the Type of Work to Be Performed on the Financial Information of Components
(Ref: Para. 26-27)

A47. The group engagement team's determination of the type of work to be performed on the financial information of a component and its involvement in the work of the component auditor is affected by:

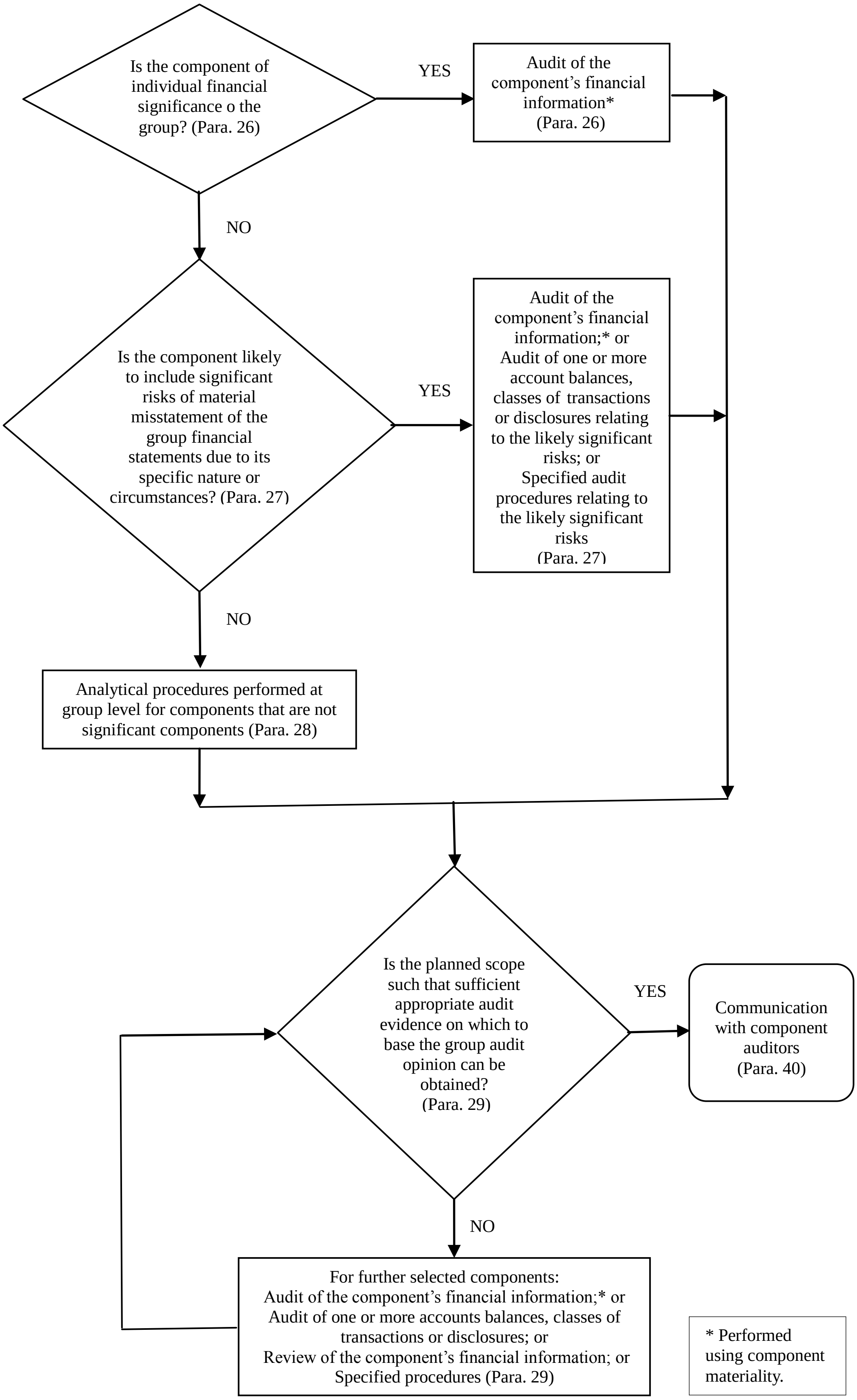
(a) The significance of the component;

(b) The identified significant risks of material misstatement of the group financial statements;

(c) The group engagement team's evaluation of the design of group-wide controls and determination whether they have been implemented; and

(d) The group engagement team's understanding of the component auditor.

The diagram shows how the significance of the component affects the group engagement team's determination of the type of work to be performed on the financial information of the component.


Is the component of individual financial significance o the group? (Para. 26)
YES
Audit of the component's financial information* (Para. 26)
NO
Is the component likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances? (Para. 27)
YES
Audit of the component's financial information;* or Audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks; or Specified audit procedures relating to the likely significant risks (Para. 27)
NO
Analytical procedures performed at group level for components that are not significant components (Para. 28)
Is the planned scope such that sufficient appropriate audit evidence on which to base the group audit opinion can be obtained? (Para. 29)
YES
Communication with component auditors (Para. 40)
NO
For further selected components:
Audit of the component's financial information;* or
Audit of one or more accounts balances, classes of transactions or disclosures; or
Review of the component's financial information; or
Specified procedures (Para. 29)
* Performed using component materiality.

Significant Components (Ref: Para. 27(b)-(c))

A48. The group engagement team may identify a component as a significant component because that component is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances. In that case, the group engagement team may be able to identify the account balances, classes of transactions or disclosures affected by the likely significant risks. Where this is the case, the group engagement team may decide to perform, or request a component auditor to perform, an audit of only those account balances, classes of transactions or disclosures. For example, in the situation described in paragraph A6, the work on the financial information of the component may be limited to an audit of the account balances, classes of transactions and disclosures affected by the foreign exchange trading of that component. Where the group engagement team requests a component auditor to perform an audit of one or more specific account balances, classes of transactions or disclosures, the communication of the group engagement team (see paragraph 40) takes account of the fact that many financial statement items are interrelated.

A49. The group engagement team may design audit procedures that respond to a likely significant risk of material misstatement of the group financial statements. For example, in the case of a likely significant risk of inventory obsolescence, the group engagement team may perform, or request a component auditor to perform, specified audit procedures on the valuation of inventory at a component that holds a large volume of potentially obsolete inventory, but that is not otherwise significant.

Components that Are Not Significant Components (Ref: Para. 28-29)

A50. Depending on the circumstances of the engagement, the financial information of the components may be aggregated at various levels for purposes of the analytical procedures. The results of the analytical procedures corroborate the group engagement team's conclusions that there are no significant risks of material misstatement of the aggregated financial information of components that are not significant components.

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

- The extent of audit evidence expected to be obtained on the financial information of the significant components.
- Whether the component has been newly formed or acquired.
- Whether significant changes have taken place in the component.
- Whether the internal audit function has performed work at the component and any effect of that work on the group audit.
- Whether the components apply common systems and processes.
- The operating effectiveness of group-wide controls.
- Abnormal fluctuations identified by analytical procedures performed at group level.
- The individual financial significance of, or the risk posed by, the component in comparison with other components within this category.
- Whether the component is subject to audit required by statute, regulation or for another reason.

Including an element of unpredictability in selecting components in this category may increase the likelihood of identifying material misstatement of the components' financial information. The selection of components is often varied on a cyclical basis.

A52. A review of the financial information of a component may be performed in accordance with Hong Kong Standard on Review Engagements (HKSRE) 2400 [22] or HKSRE 2410,[23] adapted as necessary in the circumstances. The group engagement team may also specify additional procedures to supplement this work.

A53. As explained in paragraph A13, a group may consist only of components that are not significant components. In these circumstances, the group engagement team can obtain sufficient appropriate audit evidence on which to base the group audit opinion by determining the type of work to be performed on the financial information of the components in accordance with paragraph 29. It is unlikely that the group engagement team will obtain sufficient appropriate audit evidence on which to base the group audit opinion if the group engagement team, or a component auditor, only tests group-wide controls and performs analytical procedures on the financial information of the components.

Involvement in the Work Performed by Component Auditors (Ref: Para. 30-31)

A54. Factors that may affect the group engagement team's involvement in the work of the component auditor include:

(a) The significance of the component;

(b) The identified significant risks of material misstatement of the group financial statements; and

(c) The group engagement team's understanding of the component auditor.

In the case of a significant component or identified significant risks, the group engagement team performs the procedures described in paragraphs 30-31. In the case of a component that is not a significant component, the nature, timing and extent of the group engagement team's involvement in the work of the component auditor will vary based on the group engagement team's understanding of that component auditor. The fact that the component is not a significant component becomes secondary. For example, even though a component is not considered a significant component, the group engagement team nevertheless may decide to be involved in the component auditor's risk assessment, because it has less than serious concerns about the component auditor's professional competency (for example, lack of industry specific knowledge), or the component auditor does not operate in an environment that actively oversees auditors.

A55. Forms of involvement in the work of a component auditor other than those described in paragraphs 30-31 and 42 may, based on the group engagement team's understanding of the component auditor, include one or more of the following:

(a) Meeting with component management or the component auditors to obtain an understanding of the component and its environment.

(b) Reviewing the component auditors' overall audit strategy and audit plan.

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22 HKSRE 2400, *Engagements to Review Financial Statements*

23 HKSRE 2410, *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*

(c) Performing risk assessment procedures to identify and assess the risks of material misstatement at the component level. These may be performed with the component auditors, or by the group engagement team.

(d) Designing and performing further audit procedures. These may be designed and performed with the component auditors, or by the group engagement team.

(e) Participating in the closing and other key meetings between the component auditors and component management.

(f) Reviewing other relevant parts of the component auditors' audit documentation.

Consolidation Process

Consolidation Adjustments and Reclassifications (Ref: Para. 34)

A56. The consolidation process may require adjustments to amounts reported in the group financial statements that do not pass through the usual transaction processing systems, and may not be subject to the same internal controls to which other financial information is subject. The group engagement team's evaluation of the appropriateness, completeness and accuracy of the adjustments may include:

- Evaluating whether significant adjustments appropriately reflect the events and transactions underlying them;

- Determining whether significant adjustments have been correctly calculated, processed and authorized by group management and, where applicable, by component management;

- Determining whether significant adjustments are properly supported and sufficiently documented; and

- Checking the reconciliation and elimination of intra-group transactions and unrealized profits, and intra-group account balances.

Communication with the Component Auditor [23a] (Ref: Para. 40-41)

A57. If effective two-way communication between the group engagement team and the component auditors does not exist, there is a risk that the group engagement team may not obtain sufficient appropriate audit evidence on which to base the group audit opinion. Clear and timely communication of the group engagement team's requirements forms the basis of effective two-way communication between the group engagement team and the component auditor.

A58. The group engagement team's requirements are often communicated in a letter of instruction. Appendix 5 contains guidance on required and additional matters that may be included in such a letter of instruction. The component auditor's communication with the group engagement team often takes the form of a memorandum or report of work performed. Communication between the group engagement team and the component auditor, however, may not necessarily be in writing. For example, the group engagement team may visit the component auditor to discuss identified significant risks or review relevant parts of the component auditor's audit documentation. Nevertheless, the documentation requirements of this and other HKSAs apply.

[23a] Additional local guidance is provided in Appendix 6.

A59. In cooperating with the group engagement team, the component auditor, for example, would provide the group engagement team with access to relevant audit documentation if not prohibited by law or regulation.

A60. Where a member of the group engagement team is also a component auditor, the objective for the group engagement team to communicate clearly with the component auditor can often be achieved by means other than specific written communication. For example:

- Access by the component auditor to the overall audit strategy and audit plan may be sufficient to communicate the group engagement team's requirements set out in paragraph 40; and

- A review of the component auditor's audit documentation by the group engagement team may be sufficient to communicate matters relevant to the group engagement team's conclusion set out in paragraph 41.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Reviewing the Component Auditor's Audit Documentation (Ref: Para. 42(b))

A61. What parts of the audit documentation of the component auditor will be relevant to the group audit may vary depending on the circumstances. Often the focus is on audit documentation that is relevant to the significant risks of material misstatement of the group financial statements. The extent of the review may be affected by the fact that the component auditor's audit documentation has been subjected to the component auditor's firm's review procedures.

Sufficiency and Appropriateness of Audit Evidence (Ref: Para. 44-45)

A62. If the group engagement team concludes that sufficient appropriate audit evidence on which to base the group audit opinion has not been obtained, the group engagement team may request the component auditor to perform additional procedures. If this is not feasible, the group engagement team may perform its own procedures on the financial information of the component.

A63. The group engagement partner's evaluation of the aggregate effect of any misstatements (either identified by the group engagement team or communicated by component auditors) allows the group engagement partner to determine whether the group financial statements as a whole are materially misstated.

Communication with Group Management and Those Charged with Governance of the Group

Communication with Group Management (Ref: Para. 46-48)

A64. HKSA 240 contains requirements and guidance on communication of fraud to management and, where management may be involved in the fraud, to those charged with governance.[24]

A65. Group management may need to keep certain material sensitive information confidential. Examples of matters that may be significant to the financial statements of the component of which component management may be unaware include the following:

- Potential litigation.

- Plans for abandonment of material operating assets.

[24] HKSA 240, paragraphs 40-42

- Subsequent events.
- Significant legal agreements.

Communication with Those Charged with Governance of the Group (Ref: Para. 49)

A66. The matters the group engagement team communicates to those charged with governance of the group may include those brought to the attention of the group engagement team by component auditors that the group engagement team judges to be significant to the responsibilities of those charged with governance of the group. Communication with those charged with governance of the group takes place at various times during the group audit. For example, the matters referred to in paragraph 49(a)-(b) may be communicated after the group engagement team has determined the work to be performed on the financial information of the components. On the other hand, the matter referred to in paragraph 49(c) may be communicated at the end of the audit, and the matters referred to in paragraph 49(d)-(e) may be communicated when they occur.

Appendix 1

(Ref: Para. A19)

Illustration of Independent Auditor's Report Where the Group Engagement Team Is Not Able to Obtain Sufficient Appropriate Audit Evidence on Which to Base the Group Audit Opinion

Note: Throughout these illustrative auditor's reports, the Opinion section has been positioned first in accordance with HKSA 700 (Revised), and the Basis for Opinion section is positioned immediately after the Opinion section. Also, the first and last sentence that was included in the extant auditor's responsibilities section is now subsumed as part of the new Basis for Opinion section.

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is a group audit (i.e. HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the consolidated financial statements in HKSA 210.
- The group engagement team is unable to obtain sufficient appropriate audit evidence relating to a significant component accounted for by the equity method (recognized at $15 million in the statement of financial position, which reflects total assets of $60 million) because the group engagement team did not have access to the accounting records, management, or auditor of the component[1a].
- The group engagement team has read the audited financial statements of the component as at 31 December 20X1, including the auditor's report thereon, and considered related financial information kept by group management in relation to the component.
- In the group engagement partner's judgment, the effect on the group financial statements of this inability to obtain sufficient appropriate audit evidence is material but not pervasive.[1]
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).[2]
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.[3]

[1a] Additional local guidance is provided in Appendix 6.

[1] If, in the group engagement partner’s judgment, the effect on the group financial statements of the inability to obtain sufficient appropriate audit evidence is material and pervasive, the group engagement partner would disclaim an opinion in accordance with HKSA 705 (Revised).

[2] HKSA 570 (Revised), *Going Concern*

[3] HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

- The auditor has obtained all of the other information prior to the date of the auditor's report and the qualified opinion on the consolidated financial statements also affects the other information.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[3a]

Report on the Audit of the Consolidated Financial Statements[4]

Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries ("the Group") set out on pages … to …, which comprise the consolidated statement of financial position as at 31 December 20X1, and [the consolidated statement of profit or loss and][4a] the consolidated statement of profit or loss and other comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the consolidated financial statements give a true and fair view of the financial position of the Group as at 31 December 20X1, and of their financial performance and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Qualified Opinion

ABC Company's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at $15 million on the consolidated statement of financial position as at 31 December 20X1, and ABC's share of XYZ's net income of $1 million is included in the consolidated [statement of profit or loss][statement of profit or loss and other comprehensive income][4a] for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at 31 December 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, the directors, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

3a In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

4 Not used.

4a HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised)*[5] *– see Illustration 6 in Appendix 2 of HKSA 720 (Revised). The last paragraph of the other information section in Illustration 6 would be customized to describe the specific matter giving rise to the qualified opinion that also affects the other information.*]

Responsibilities of Directors and Those Charged with Corporate Governance for the Consolidated Financial Statements [6]

[*Reporting in accordance with HKSA 700 (Revised)*[7] *– see Illustration 4 in HKSA 700 (Revised*).]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 4 in HKSA 700 (Revised*).]

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5 HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

6 Throughout these illustrative auditor's reports, the terms directors and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

7 HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Report on Other Matters under sections 407(2)[7a] and 407(3)[7a] of the Hong Kong Companies Ordinance[7b]

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate as described in the *Basis for Qualified Opinion* section of our report:

- we were unable to determine whether adequate accounting records had been kept; and
- we have not obtained all the information and explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[*Auditor's Address*]

[*Date*]

7a Section 407 of the CO requires the auditor to opine on other matters:

(1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
   (a) whether adequate accounting records have been kept by the company; and
   (b) whether the financial statements are in agreement with the accounting records.

(2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
   (a) adequate accounting records have not been kept by the company; or
   (b) the financial statements are not in agreement with the accounting records in any material respect.

(3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.

(4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

7b For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 "Reports by auditors under the Hong Kong Companies Ordinance".

Appendix 2

(Ref: Para. A23)

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

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

Group-Wide Controls

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

   - Regular meetings between group and component management to discuss business developments and to review performance.
   - Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets, and to take appropriate action.
   - Group management's risk assessment process, that is, the process for identifying, analyzing and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements.
   - Monitoring, controlling, reconciling, and eliminating intra-group transactions and unrealized profits, and intra-group account balances at group level.
   - A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components.
   - A central IT system controlled by the same general IT controls for all or part of the group.
   - Control activities within an IT system that is common for all or some components.
   - Monitoring of controls, including activities of the internal audit function and self-assessment programs.
   - Consistent policies and procedures, including a group financial reporting procedures manual.
   - Group-wide programs, such as codes of conduct and fraud prevention programs.
   - Arrangements for assigning authority and responsibility to component management.

2. The internal audit function may be regarded as part of group-wide controls, for example, when the function is centralized. HKSA 610 (Revised 2013) [1] deals with the group engagement team's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately supports the objectivity of internal auditors, the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach where the group audit team expects to use the function's work.

[1] HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 15

Consolidation Process

3. The group engagement team's understanding of the consolidation process may include matters such as the following:

Matters relating to the applicable financial reporting framework:

- The extent to which component management has an understanding of the applicable financial reporting framework.
- The process for identifying and accounting for components in accordance with the applicable financial reporting framework.
- The process for identifying reportable segments for segment reporting in accordance with the applicable financial reporting framework.
- The process for identifying related party relationships and related party transactions for reporting in accordance with the applicable financial reporting framework.
- The accounting policies applied to the group financial statements, changes from those of the previous financial year, and changes resulting from new or revised standards under the applicable financial reporting framework.
- The procedures for dealing with components with financial year-ends different from the group's year-end.

Matters relating to the consolidation process:

- Group management's process for obtaining an understanding of the accounting policies used by components, and, where applicable, ensuring that uniform accounting policies are used to prepare the financial information of the components for the group financial statements, and that differences in accounting policies are identified, and adjusted where required in terms of the applicable financial reporting framework. Uniform accounting policies are the specific principles, bases, conventions, rules, and practices adopted by the group, based on the applicable financial reporting framework, that the components use to report similar transactions consistently. These policies are ordinarily described in the financial reporting procedures manual and reporting package issued by group management.
- Group management's process for ensuring complete, accurate and timely financial reporting by the components for the consolidation.
- The process for translating the financial information of foreign components into the currency of the group financial statements.
- How IT is organized for the consolidation, including the manual and automated stages of the process, and the manual and programmed controls in place at various stages of the consolidation process.
- Group management's process for obtaining information on subsequent events.

Matters relating to consolidation adjustments:

- The process for recording consolidation adjustments, including the preparation, authorization and processing of related journal entries, and the experience of personnel responsible for the consolidation.

- The consolidation adjustments required by the applicable financial reporting framework.
- Business rationale for the events and transactions that gave rise to the consolidation adjustments.
- Frequency, nature and size of transactions between components.
- Procedures for monitoring, controlling, reconciling and eliminating intra-group transactions and unrealized profits, and intra-group account balances.
- Steps taken to arrive at the fair value of acquired assets and liabilities, procedures for amortizing goodwill (where applicable), and impairment testing of goodwill, in accordance with the applicable financial reporting framework.
- Arrangements with a majority owner or minority interests regarding losses incurred by a component (for example, an obligation of the minority interest to make good such losses).

Appendix 3

(Ref: Para. A30)

Examples of Conditions or Events that May Indicate Risks of Material Misstatement of the Group Financial Statements

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

- A complex group structure, especially where there are frequent acquisitions, disposals or reorganizations.

- Poor corporate governance structures, including decision-making processes, that are not transparent.

- Non-existent or ineffective group-wide controls, including inadequate group management information on monitoring of components' operations and their results.

- Components operating in foreign jurisdictions that may be exposed to factors such as unusual government intervention in areas such as trade and fiscal policy, and restrictions on currency and dividend movements; and fluctuations in exchange rates.

- Business activities of components that involve high risk, such as long-term contracts or trading in innovative or complex financial instruments.

- Uncertainties regarding which components' financial information require incorporation in the group financial statements in accordance with the applicable financial reporting framework, for example, whether any special-purpose entities or non-trading entities exist and require incorporation.

- Unusual related party relationships and transactions.

- Prior occurrences of intra-group account balances that did not balance or reconcile on consolidation.

- The existence of complex transactions that are accounted for in more than one component.

- Components' application of accounting policies that differ from those applied to the group financial statements.

- Components with different financial year-ends, which may be utilized to manipulate the timing of transactions.

- Prior occurrences of unauthorized or incomplete consolidation adjustments.

- Aggressive tax planning within the group, or large cash transactions with entities in tax havens.

- Frequent changes of auditors engaged to audit the financial statements of components.

Appendix 4

(Ref: Para. A35)

Examples of a Component Auditor's Confirmations

The following is not intended to be a standard letter. Confirmations may vary from one component auditor to another and from one period to the next.

Confirmations often are obtained before work on the financial information of the component commences.

[Component Auditor Letterhead]

[Date]

[To Group Engagement Partner]

This letter is provided in connection with your audit of the group financial statements of [name of parent] for the year ended [date] for the purpose of expressing an opinion on whether the group financial statements present fairly, in all material respects (give a true and fair view of) the financial position of the group as at [date] and (of) its financial performance and cash flows for the year then ended in accordance with [indicate applicable financial reporting framework].

We acknowledge receipt of your instructions dated [date], requesting us to perform the specified work on the financial information of [name of component] for the year ended [date].

We confirm that:

1. We will be able to comply with the instructions. / We advise you that we will not be able to comply with the following instructions [specify instructions] for the following reasons [specify reasons].

2. The instructions are clear and we understand them. / We would appreciate it if you could clarify the following instructions [specify instructions].

3. We will cooperate with you and provide you with access to relevant audit documentation.

We acknowledge that:

1. The financial information of [name of component] will be included in the group financial statements of [name of parent].

2. You may consider it necessary to be involved in the work you have requested us to perform on the financial information of [name of component] for the year ended [date].

3. You intend to evaluate and, if considered appropriate, use our work for the audit of the group financial statements of [name of parent].

In connection with the work that we will perform on the financial information of [name of component], a [describe component, for example, wholly-owned subsidiary, subsidiary, joint venture, investee accounted for by the equity or cost methods of accounting] of [name of parent], we confirm the following:

1. We have an understanding of [indicate relevant ethical requirements] that is sufficient to fulfill our responsibilities in the audit of the group financial statements, and will comply therewith. In particular, and with respect to [name of parent] and the other components in the group, we are independent within the meaning of [indicate relevant ethical requirements] and comply with the applicable requirements of [refer to rules] promulgated by [name of regulatory agency].

2. We have an understanding of Hong Kong Standards on Auditing and [indicate other national standards applicable to the audit of the group financial statements] that is sufficient to fulfill our responsibilities in the audit of the group financial statements and will conduct our work on the financial information of [name of component] for the year ended [date] in accordance with those standards.

3. We possess the special skills (for example, industry specific knowledge) necessary to perform the work on the financial information of the particular component.

4. We have an understanding of [indicate applicable financial reporting framework or group financial reporting procedures manual] that is sufficient to fulfill our responsibilities in the audit of the group financial statements.

We will inform you of any changes in the above representations during the course of our work on the financial information of [name of component].

[Auditor's signature]

[Date]

[Auditor's address]

Appendix 5

(Ref: Para. A58)

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

Matters required by this HKSA to be communicated to the component auditor are shown in italicized text.

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

- *A request for the component auditor, knowing the context in which the group engagement team will use the work of the component auditor, to confirm that the component auditor will cooperate with the group engagement team*.
- The timetable for completing the audit.
- Dates of planned visits by group management and the group engagement team, and dates of planned meetings with component management and the component auditor.
- A list of key contacts.
- *The work to be performed by the component auditor, the use to be made of that work*, and arrangements for coordinating efforts at the initial stage of and during the audit, including the group engagement team's planned involvement in the work of the component auditor.
- *The ethical requirements that are relevant to the group audit and, in particular, the independence requirements, for example, where the group auditor is prohibited by law or regulation from using internal auditors to provide direct assistance, it is relevant for the group auditor to consider whether the prohibition also extends to component auditors and, if so, to address this in the communication to the component auditors.* [1]
- *In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures), and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.*
- *A list of related parties prepared by group management, and any other related parties that the group engagement team is aware of, and a request that the component auditor communicates on a timely basis to the group engagement team related parties not previously identified by group management or the group engagement team.*
- Work to be performed on intra-group transactions and unrealized profits and intra-group account balances.
- Guidance on other statutory reporting responsibilities, for example reporting on group management's assertion on the effectiveness of internal control.
- Where time lag between completion of the work on the financial information of the components and the group engagement team's conclusion on the group financial statements is likely, specific instructions for a subsequent events review.

[1] HKSA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph A31

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

- The findings of the group engagement team's tests of control activities of a processing system that is common for all or some components, and tests of controls to be performed by the component auditor.

- *Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor, and a request that the component auditor communicates on a timely basis any other significant risks of material misstatement of the group financial statements, due to fraud or error, identified in the component and the component auditor's response to such risks.*

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

- A request for timely communication of audit evidence obtained from performing work on the financial information of the components that contradicts the audit evidence on which the group engagement team originally based the risk assessment performed at group level.

- A request for a written representation on component management's compliance with the applicable financial reporting framework, or a statement that differences between the accounting policies applied to the financial information of the component and those applied to the group financial statements have been disclosed.

- Matters to be documented by the component auditor.

Other information

- A request that the following be reported to the group engagement team on a timely basis:

    - Significant accounting, financial reporting and auditing matters, including accounting estimates and related judgments.

    - Matters relating to the going concern status of the component.

    - Matters relating to litigation and claims.

    - Significant deficiencies in internal control that the component auditor has identified during the performance of the work on the financial information of the component, and information that indicates the existence of fraud.

- A request that the group engagement team be notified of any significant or unusual events as early as possible.

- *A request that the matters listed in paragraph 41 be communicated to the group engagement team when the work on the financial information of the component is completed.*

Appendix 6

(Ref: Para. 40)

Additional Local Guidance on Communication with the Component Auditor

1. The group auditor is fully responsible for the auditor's opinion on the consolidated financial statements. Section 412 of the Companies Ordinance empowers an auditor to require information and explanation for the performance of the duties as auditor from the following persons, including:

   (a) an officer of the company;

   (b) the subsidiary undertaking;

   (c) a person who—

      (i) is an officer or auditor of the subsidiary undertaking; or

      (ii) was an officer or auditor of the subsidiary undertaking at the time to which the information or explanation relates; and

   (d) a person who—

      (i) holds or is accountable for any of the subsidiary undertaking's accounting records; or

      (ii) held or was accountable for the subsidiary undertaking's accounting records at the time to which the information or explanation relates.

   If a subsidiary undertaking of a company is not a company incorporated in Hong Kong, an auditor of the company may require the company to obtain from any of the persons specified in (b) to (d) above any information or explanation that the auditor reasonably requires for the performance of the duties as auditor of the company. In accordance with paragraph 11 of this HKSA, the auditor's report on the consolidated financial statements shall not refer to the fact that the financial statements of some subsidiaries or associates have been audited by other auditors.

HKSA 700 (Revised)
Issued August 2015; revised January 2016, August 2016,
June 2017

Effective for audits of financial statements
for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 700 (Revised)

Forming an Opinion and Reporting on Financial Statements

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

HONG KONG STANDARD ON AUDITING 700 (REVISED) FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods ending on or after 15 December 2016)

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Hong Kong Standard on Auditing (HKSA) 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibility to form an opinion on the financial statements. It also deals with the form and content of the auditor's report issued as a result of an audit of financial statements.

2. HKSA 701[1] deals with the auditor's responsibility to communicate key audit matters in the auditor's report. HKSA 705[2] (Revised) and HKSA 706[3] (Revised) deal with how the form and content of the auditor's report are affected when the auditor expresses a modified opinion or includes an Emphasis of Matter paragraph or an Other Matter paragraph in the auditor's report. Other HKSAs also contain reporting requirements that are applicable when issuing an auditor's report.

3. This HKSA applies to an audit of a complete set of general purpose financial statements and is written in that context. HKSA 800 (Revised)[4] deals with special considerations when financial statements are prepared in accordance with a special purpose framework. HKSA 805 (Revised)[5] deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement. This HKSA also applies to audits for which HKSA 800 (Revised) or HKSA 805 (Revised) apply.

4. The requirements of this HKSA are aimed at addressing an appropriate balance between the need for consistency and comparability in auditor reporting globally and the need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users. This HKSA promotes consistency in the auditor's report, but recognizes the need for flexibility to accommodate particular circumstances of individual jurisdictions. Consistency in the auditor's report, when the audit has been conducted in accordance with HKSAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. It also helps to promote the user's understanding and to identify unusual circumstances when they occur.

Effective Date

5. This HKSA is effective for audits of financial statements for periods ending on or after 15 December 2016.

Objectives

6. The objectives of the auditor are:

    (a) To form an opinion on the financial statements based on an evaluation of the conclusions drawn from the audit evidence obtained; and

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[1] HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

[2] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

[3] HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

[4] HKSA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

[5] HKSA 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

(b) To express clearly that opinion through a written report.

Definitions

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

   (a) General purpose financial statements – Financial statements prepared in accordance with a general purpose framework.

   (b) General purpose framework – A financial reporting framework designed to meet the common financial information needs of a wide range of users. The financial reporting framework may be a fair presentation framework or a compliance framework.

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

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

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

   The term "compliance framework" is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements in (i) or (ii) above.[6]

   (c) Unmodified opinion – The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.[7]

8. Reference to "financial statements" in this HKSA means "a complete set of general purpose financial statements.[8] The requirements of the applicable financial reporting framework determine the presentation, structure and content of the financial statements, and what constitutes a complete set of financial statements.

9. Reference to "Hong Kong Financial Reporting Standards" in this HKSA means the Hong Kong Financial Reporting Standards (HKFRSs) issued by the Hong Kong Institute of Certified Public Accountants (HKICPA).

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6 HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 13(a)

7 Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

8 HKSA 200, paragraph 13(f) sets out the content of financial statements.

Requirements

Forming an Opinion on the Financial Statements

10. The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.[9,10]

11. In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

    (a) The auditor's conclusion, in accordance with HKSA 330, whether sufficient appropriate audit evidence has been obtained;[11]

    (b) The auditor's conclusion, in accordance with HKSA 450, whether uncorrected misstatements are material, individually or in aggregate;[12] and

    (c) The evaluations required by paragraphs 12–15.

12. The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A1–A3)

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

    (a) The financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor shall consider the relevance of the accounting policies to the entity, and whether they have been presented in an understandable manner; (Ref: Para. A4)

    (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

    (c) The accounting estimates made by management are reasonable;

    (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor shall consider whether

    - The information that should have been included has been included, and whether such information is appropriately classified, aggregated or disaggregated, and characterized.
    - The overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed. (Ref: Para. A5)

    (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A6)

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[9] HKSA 200, paragraph 11

[10] Paragraphs 25–26 deal with the phrases used to express this opinion in the case of a fair presentation framework and a compliance framework respectively.

[11] HKSA 330, *The Auditor's Responses to Assessed Risks*, paragraph 26

[12] HKSA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

(f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

14. When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs 12–13 shall also include whether the financial statements achieve fair presentation. The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of: (Ref: Para A7-A9)

    (a) The overall presentation, structure and content of the financial statements; and

    (b) Whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

15. The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. (Ref: Para. A10–A15)

Form of Opinion

16. The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

17. If the auditor:

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

    (b) is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

    the auditor shall modify the opinion in the auditor's report in accordance with HKSA 705 (Revised).

18. If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with HKSA 705 (Revised). (Ref: Para. A16)

19. When the financial statements are prepared in accordance with a compliance framework, the auditor is not required to evaluate whether the financial statements achieve fair presentation. However, if in extremely rare circumstances the auditor concludes that such financial statements are misleading, the auditor shall discuss the matter with management and, depending on how it is resolved, shall determine whether, and how, to communicate it in the auditor's report. (Ref: Para. A17)

Auditor's Report

20. The auditor's report shall be in writing. (Ref: Para. A18–A19)

Auditor's Report for Audits Conducted in Accordance with Hong Kong Standards on Auditing

Title

21. The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor. (Ref: Para. A20)

Addressee

22. The auditor's report shall be addressed, as appropriate, based on the circumstances of the engagement. (Ref: Para. A21)

Auditor's Opinion

23. The first section of the auditor's report shall include the auditor's opinion, and shall have the heading "Opinion."

24. The Opinion section of the auditor's report shall also:

    (a) Identify the entity whose financial statements have been audited;

    (b) State that the financial statements have been audited;

    (c) Identify the title of each statement comprising the financial statements;

    (d) Refer to the notes, including the summary of significant accounting policies; and

    (e) Specify the date of, or period covered by, each financial statement comprising the financial statements. (Ref: Para. A22–A23)

25. When expressing an unmodified opinion on financial statements prepared in accordance with a fair presentation framework, the auditor's opinion shall, unless otherwise required by law or regulation, use one of the following phrases, which are regarded as being equivalent:

    (a) In our opinion, the accompanying financial statements present fairly, in all material respects, […] in accordance with [the applicable financial reporting framework]; or

    (b) In our opinion, the accompanying financial statements give a true and fair view of […] in accordance with [the applicable financial reporting framework].[12a] (Ref: Para. A24–A31)

26. When expressing an unmodified opinion on financial statements prepared in accordance with a compliance framework, the auditor's opinion shall be that the accompanying financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework]. (Ref: Para. A26–A31)

27. If the reference to the applicable financial reporting framework in the auditor's opinion is not to HKFRSs issued by the HKICPA, the auditor's opinion shall identify the jurisdiction of origin of the framework.

Basis for Opinion

28. The auditor's report shall include a section, directly following the Opinion section, with the heading "Basis for Opinion", that: (Ref: Para. A32)

    (a) States that the audit was conducted in accordance with Hong Kong Standards on Auditing; (Ref: Para. A33)

    (b) Refers to the section of the auditor's report that describes the auditor's responsibilities under the HKSAs;

    (c) Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall

[12a] In Hong Kong, the Companies Ordinance, the Main Board Listing Rules and GEM Listing Rules adopt the phrase "true and fair view".

identify the jurisdiction of origin of the relevant ethical requirements or refer to the HKICPA's *Code of Ethics for Professional Accountants* (the Code); and (Ref: Para. A34–A39)

(d) States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Going Concern

29. Where applicable, the auditor shall report in accordance with HKSA 570 (Revised).[13]

Key Audit Matters

30. For audits of complete sets of general purpose financial statements of listed entities, the auditor shall communicate key audit matters in the auditor's report in accordance with HKSA 701.

31. When the auditor is otherwise required by law or regulation or decides to communicate key audit matters in the auditor's report, the auditor shall do so in accordance with HKSA 701. (Ref: Para. A40–A42)

Other Information

32. Where applicable, the auditor shall report in accordance with HKSA 720 (Revised).[14]

Responsibilities for the Financial Statements

33. The auditor's report shall include a section with a heading "Responsibilities of Management for the Financial Statements." The auditor's report shall use the term that is appropriate in the context of the legal framework in the particular jurisdiction and need not refer specifically to "management". In some jurisdictions, the appropriate reference may be to those charged with governance.[14a] (Ref: Para. A44)

34. This section of the auditor's report shall describe management's responsibility for: (Ref: Para. A45–A48)

(a) Preparing the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

(b) Assessing the entity's ability to continue as a going concern[15] and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate. (Ref: Para. A48)

35. This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described in paragraph 34 above. In this case, the heading of this section

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[13] HKSA 570 (Revised), *Going Concern*, paragraphs 21–23

[14] HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

[14a] In Hong Kong, under the Hong Kong Companies Ordinance, directors are responsible for the preparation of financial statements that give a true and fair view.

[15] HKSA 570 (Revised), paragraph 2

shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework in the particular jurisdiction. (Ref: Para. A49)

36. When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

Auditor's Responsibilities for the Audit of the Financial Statements

37. The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements."

38. This section of the auditor's report shall: (Ref: Para. A50)

(a) State that the objectives of the auditor are to:

(i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

(ii) Issue an auditor's report that includes the auditor's opinion. (Ref: Para. A51)

(b) State that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists; and

(c) State that misstatements can arise from fraud or error, and either:

(i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements; or [16]

(ii) Provide a definition or description of materiality in accordance with the applicable financial reporting framework. (Ref: Para. A53)

39. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further: (Ref: Para. A50)

(a) State that, as part of an audit in accordance with HKSAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and

(b) Describe an audit by stating that the auditor's responsibilities are:

(i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion

[16] HKSA 320, *Materiality in Planning and Performing an Audit,* paragraph 2

on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

(iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(c) When HKSA 600[17] applies, further describe the auditor's responsibilities in a group audit engagement by stating that:

(i) The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the group to express an opinion on the group financial statements;

(ii) The auditor is responsible for the direction, supervision and performance of the group audit; and

(iii) The auditor remains solely responsible for the auditor's opinion.

40. The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall: (Ref: Para. A50)

(a) State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit;

(b) For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards; and

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

(c) For audits of financial statements of listed entities and any other entities for which key audit matters are communicated in accordance with HKSA 701, state that, from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication. (Ref: Para. A53)

Location of the description of the auditor's responsibilities for the audit of the financial statements

41. The description of the auditor's responsibilities for the audit of the financial statements required by paragraphs 39–40 shall be included: (Ref: Para. A54)

(a) Within the body of the auditor's report;

(b) Within an appendix to the auditor's report, in which case the auditor's report shall include a reference to the location of the appendix; or (Ref: Para. A55–A57)

(c) By a specific reference within the auditor's report to the location of such a description on a website of an appropriate authority[17a], where law, regulation or HKSAs expressly permit the auditor to do so. (Ref: Para. A54, A56–A57)

42. When the auditor refers to a description of the auditor's responsibilities on a website of an appropriate authority, the auditor shall determine that such description addresses, and is not inconsistent with, the requirements in paragraphs 39–40 of this HKSA. (Ref: Para. A56)

Other Reporting Responsibilities

43. If the auditor addresses other reporting responsibilities[17b] in the auditor's report on the financial statements that are in addition to the auditor's responsibilities under the HKSAs, these other reporting responsibilities shall be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the content of the section, unless these other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSAs in which case the other reporting responsibilities may be presented in the same section as the related report elements required by the HKSAs. (Ref: Para. A58–A60)

44. If other reporting responsibilities are presented in the same section as the related report elements required by the HKSAs, the auditor's report shall clearly differentiate the other reporting responsibilities from the reporting that is required by the HKSAs. (Ref: Para. A60)

45. If the auditor's report contains a separate section that addresses other reporting responsibilities, the requirements of paragraphs 21–40 of this HKSA shall be included under a section with a heading "Report on the Audit of the Financial Statements." The "Report on Other Legal and Regulatory Requirements" shall follow the "Report on the Audit of the Financial Statements." (Ref: Para. A60)

[17a] A description of auditor's responsibilities for the audit of the financial statements of an entity incorporated in Hong Kong can be found in the HKICPA's website at http://www.hkicpa.org.hk/en/standards-and-regulations/standards/auditing-assurance/auditre/

[17b] For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 (Revised), *Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)*.

Name of the Engagement Partner

46. The name of the engagement partner shall be included in the auditor's report on financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat. In the rare circumstances that the auditor intends not to include the name of the engagement partner in the auditor's report, the auditor shall discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat. (Ref: Para. A61–A63)

Signature of the Auditor

47. The auditor's report shall be signed. (Ref: Para. A64–A65)

Auditor's Address

48. The auditor's report shall name the location in the jurisdiction where the auditor practices.

Date of the Auditor's Report

49. The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements, including evidence that: (Ref: Para. A66–A69)

    (a) All the statements and disclosures that comprise the financial statements have been prepared; and

    (b) Those with the recognized authority have asserted that they have taken responsibility for those financial statements.

Auditor's Report Prescribed by Law or Regulation

50. If the auditor is required by law or regulation of a specific jurisdiction to use a specific layout, or wording of the auditor's report, the auditor's report shall refer to Hong Kong Standards on Auditing only if the auditor's report includes, at a minimum, each of the following elements: (Ref: Para. A70–A71)

    (a) A title.

    (b) An addressee, as required by the circumstances of the engagement.

    (c) An Opinion section containing an expression of opinion on the financial statements and a reference to the applicable financial reporting framework used to prepare the financial statements (including identifying the jurisdiction of origin of the financial reporting framework that is not Hong Kong Financial Reporting Standards, see paragraph 27).

    (d) An identification of the entity's financial statements that have been audited.

    (e) A statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements or refer to the Code.

    (f) Where applicable, a section that addresses, and is not inconsistent with, the reporting requirements in paragraph 22 of HKSA 570 (Revised).

(g) Where applicable, a Basis for Qualified (or Adverse) Opinion section that addresses, and is not inconsistent with, the reporting requirements in paragraph 23 of HKSA 570 (Revised).

(h) Where applicable, a section that includes the information required by HKSA 701, or additional information about the audit that is prescribed by law or regulation and that addresses, and is not inconsistent with, the reporting requirements in that HKSA.[18] (Ref: Para. A72–A75)

(i) Where applicable, a section that addresses the reporting requirements in paragraph 24 of HKSA 720 (Revised).

(j) A description of management's responsibilities for the preparation of the financial statements and an identification of those responsible for the oversight of the financial reporting process that addresses, and is not inconsistent with, the requirements in paragraphs 33–36.

(k) A reference to Hong Kong Standards on Auditing and the law or regulation, and a description of the auditor's responsibilities for an audit of the financial statements that addresses, and is not inconsistent with, the requirements in paragraphs 37–40. (Ref: Para. A50–A53)

(l) For audits of complete sets of general purpose financial statements of listed entities, the name of the engagement partner unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat.

(m) The auditor's signature.

(n) The auditor's address.

(o) The date of the auditor's report.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and Hong Kong Standards on Auditing

51. An auditor may be required to conduct an audit in accordance with the auditing standards of a specific jurisdiction (the "other auditing standards"), and has additionally complied with the HKSAs in the conduct of the audit. If this is the case, the auditor's report may refer to Hong Kong Standards on Auditing in addition to the other auditing standards, but the auditor shall do so only if: (Ref: Para. A76–A77)

(a) There is no conflict between the requirements in the other auditing standards and those in HKSAs that would lead the auditor (i) to form a different opinion, or (ii) not to include an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by HKSAs; and

(b) The auditor's report includes, at a minimum, each of the elements set out in paragraphs 50(a)–(o) above when the auditor uses the layout or wording specified by the other auditing standards. However, reference to "law or regulation" in paragraph 50(k) shall be read as reference to the other auditing standards. The auditor's report shall thereby identify such other auditing standards.

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[18] HKSA 701, paragraphs 11–16

52. When the auditor's report refers to both the other auditing standards and Hong Kong Standards on Auditing, the auditor's report shall identify the jurisdiction of origin of the other auditing standards.

Supplementary Information Presented with the Financial Statements (Ref: Para. A78–A84)

53. If supplementary information that is not required by the applicable financial reporting framework is presented with the audited financial statements, the auditor shall evaluate whether, in the auditor's professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.

54. If supplementary information that is not required by the applicable financial reporting framework is not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor shall ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.

Conformity and Compliance with International Standards on Auditing

55. As of August 2015 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*. Compliance with the requirements of this HKSA ensures compliance with ISA 700 (Revised).

56. Additional local explanations are provided in footnotes 12a, 14a, 17a, 17b, 25a, 25b, 35a, 36a and 37a.

57. Additional local guidance is provided in the Appendix.

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Application and Other Explanatory Material

Qualitative Aspects of the Entity's Accounting Practices (Ref: Para. 12)

A1. Management makes a number of judgments about the amounts and disclosures in the financial statements.

A2. HKSA 260 (Revised) contains a discussion of the qualitative aspects of accounting practices.[19] In considering the qualitative aspects of the entity's accounting practices, the auditor may become aware of possible bias in management's judgments. The auditor may conclude that the cumulative effect of a lack of neutrality, together with the effect of uncorrected misstatements, causes the financial statements as a whole to be materially misstated. Indicators of a lack of neutrality that may affect the auditor's evaluation of whether the financial statements as a whole are materially misstated include the following:

- The selective correction of misstatements brought to management's attention during the audit (e.g., correcting misstatements with the effect of increasing reported earnings, but not correcting misstatements that have the effect of decreasing reported earnings).

[19] HKSA 260 (Revised), *Communication with Those Charged with Governance*, Appendix 2

- Possible management bias in the making of accounting estimates.

A3. HKSA 540 addresses possible management bias in making accounting estimates.[20] Indicators of possible management bias do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. They may, however, affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement.

Accounting Policies Appropriately Disclosed in the Financial Statements (Ref: Para. 13(a))

A4. In evaluating whether the financial statements appropriately disclose the significant accounting policies selected and applied, the auditor's consideration includes matters such as:

- Whether all disclosures related to the significant accounting policies that are required to be included by the applicable financial reporting framework have been disclosed;
- Whether the information about the significant accounting policies that has been disclosed is relevant and therefore reflects how the recognition, measurement and presentation criteria in the applicable financial reporting framework have been applied to classes of transactions, account balances and disclosures in the financial statements in the particular circumstances of the entity's operations and its environment; and
- The clarity with which the significant accounting policies have been presented.

Information Presented in the Financial Statements is Relevant, Reliable, Comparable and Understandable (Ref: Para. 13(d))

A5. Evaluating the understandability of the financial statements includes consideration of such matters as whether:

- The information in the financial statements is presented in a clear and concise manner.
- The placement of significant disclosures gives appropriate prominence to them (e.g., when there is perceived value of entity-specific information to users), and whether the disclosures are appropriately cross-referenced in a manner that would not give rise to significant challenges for users in identifying necessary information.

Disclosures of the Effect of Material Transactions and Events on the Information Conveyed in the Financial Statements (Ref: Para. 13(e))

A6. It is common for financial statements prepared in accordance with a general purpose framework to present an entity's financial position, financial performance and cash flows. Evaluating whether, in view of the applicable financial reporting framework, the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows includes consideration of such matters as:

- The extent to which the information in the financial statements is relevant and specific to the circumstances of the entity; and

[20] HKSA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, paragraph 21

- Whether the disclosures are adequate to assist the intended users to understand:
  - The nature and extent of the entity's potential assets and liabilities arising from transactions or events that do not meet the criteria for recognition (or the criteria for derecognition) established by the applicable financial reporting framework.
  - The nature and extent of risks of material misstatement arising from transactions and events.
  - The methods used and the assumptions and judgments made, and changes to them, that affect amounts presented or otherwise disclosed, including relevant sensitivity analyses.

Evaluating Whether the Financial Statements Achieve Fair Presentation (Ref: Para. 14)

A7. Some financial reporting frameworks acknowledge explicitly or implicitly the concept of fair presentation.[21] As noted in paragraph 7(b) of this HKSA, a fair presentation[22] financial reporting framework not only requires compliance with the requirements of the framework, but also acknowledges explicitly or implicitly that it may be necessary for management to provide disclosures beyond those specifically required by the framework.[23]

A8. The auditor's evaluation about whether the financial statements achieve fair presentation, both in respect of presentation and disclosure, is a matter of professional judgment. This evaluation takes into account such matters as the facts and circumstances of the entity, including changes thereto, based on the auditor's understanding of the entity and the audit evidence obtained during the audit. The evaluation also includes consideration, for example, of the disclosures needed to achieve a fair presentation arising from matters that could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of the users taken on the basis of the financial statements as a whole), such as the effect of evolving financial reporting requirements or the changing economic environment.

A9. Evaluating whether the financial statements achieve fair presentation may include, for example, discussions with management and those charged with governance about their views on why a particular presentation was chosen, as well as alternatives that may have been considered. The discussions may include, for example:

- The degree to which the amounts in the financial statements are aggregated or disaggregated, and whether the presentation of amounts or disclosures obscures useful information, or results in misleading information.
- Consistency with appropriate industry practice, or whether any departures are relevant to the entity's circumstances and therefore warranted.

Description of the Applicable Financial Reporting Framework (Ref: Para. 15)

A10. As explained in HKSA 200, the preparation of the financial statements by management and, where appropriate, those charged with governance requires the inclusion of an adequate

[21] For example, Hong Kong Financial Reporting Standards (HKFRSs) note that fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses.

[22] See HKSA 200, paragraph 13(a)

[23] For example, HKFRSs require an entity to provide additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (Hong Kong Accounting Standard 1, *Presentation of Financial Statements*, paragraph 17(c)).

description of the applicable financial reporting framework in the financial statements.[24] That description advises users of the financial statements of the framework on which the financial statements are based.

A11. A description that the financial statements are prepared in accordance with a particular applicable financial reporting framework is appropriate only if the financial statements comply with all the requirements of that framework that are effective during the period covered by the financial statements.

A12. A description of the applicable financial reporting framework that contains imprecise qualifying or limiting language (e.g., "the financial statements are in substantial compliance with Hong Kong Financial Reporting Standards") is not an adequate description of that framework as it may mislead users of the financial statements.

Reference to More than One Financial Reporting Framework

A13. In some cases, the financial statements may represent that they are prepared in accordance with two financial reporting frameworks (e.g., HKFRSs and other financial reporting framework). This may be because management is required, or has chosen, to prepare the financial statements in accordance with both frameworks, in which case both are applicable financial reporting frameworks. Such description is appropriate only if the financial statements comply with each of the frameworks individually. To be regarded as being prepared in accordance with both frameworks, the financial statements need to comply with both frameworks simultaneously and without any need for reconciling statements. In practice, simultaneous compliance is unlikely unless the jurisdiction has eliminated all barriers to compliance with it.

A14. Financial statements that are prepared in accordance with one financial reporting framework and that contain a note or supplementary statement reconciling the results to those that would be shown under another framework are not prepared in accordance with that other framework. This is because the financial statements do not include all the information in the manner required by that other framework.

A15. The financial statements may, however, be prepared in accordance with one applicable financial reporting framework and, in addition, describe in the notes to the financial statements the extent to which the financial statements comply with another framework (e.g., financial statements prepared in accordance with other framework that also describe the extent to which they comply with HKFRSs). Such description may constitute supplementary financial information as discussed in paragraph 54 and is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements.

Form of Opinion

A16. There may be cases where the financial statements, although prepared in accordance with the requirements of a fair presentation framework, do not achieve fair presentation. Where this is the case, it may be possible for management to include additional disclosures in the financial statements beyond those specifically required by the framework or, in extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements. (Ref: Para. 18)

[24] HKSA 200, paragraphs A4–A5

A17. It will be extremely rare for the auditor to consider financial statements that are prepared in accordance with a compliance framework to be misleading if, in accordance with HKSA 210, the auditor determined that the framework is acceptable.[25] (Ref: Para. 19)

Auditor's Report (Ref: Para. 20)

A18. A written report encompasses reports issued in hard copy and those using an electronic medium.

A19. The Appendix to this HKSA contains illustrations of auditor's reports on financial statements, incorporating the elements set out in paragraphs 21–49. With the exception of the Opinion and Basis for Opinion sections, this HKSA does not establish requirements for ordering the elements of the auditor's report. However, this HKSA requires the use of specific headings, which are intended to assist in making auditor's reports that refer to audits that have been conducted in accordance with HKSAs more recognizable, particularly in situations where the elements of the auditor's report are presented in an order that differs from the illustrative auditor's reports in the Appendix to this HKSA.

Auditor's Report for Audits Conducted in Accordance with Hong Kong Standards on Auditing

Title (Ref: Para. 21)

A20. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," distinguishes the independent auditor's report from reports issued by others.

Addressee (Ref: Para. 22)

A21. Law, regulation or the terms of the engagement may specify to whom the auditor's report is to be addressed in that particular jurisdiction. The auditor's report is normally addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.[25a]

Auditor's Opinion (Ref. Para. 24–26)

Reference to the financial statements that have been audited

A22. The auditor's report states, for example, that the auditor has audited the financial statements of the entity, which comprise [state the title of each financial statement comprising the complete set of financial statements required by the applicable financial reporting framework, specifying the date or period covered by each financial statement] and notes to the financial statements, including a summary of significant accounting policies.

A23. When the auditor is aware that the audited financial statements will be included in a document that contains other information, such as an annual report, the auditor may consider, if the form of presentation allows, identifying the page numbers on which the audited financial statements are presented. This helps users to identify the financial statements to which the auditor's report relates.

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[25] HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

[25a] In Hong Kong, an auditor of a company incorporated under the Hong Kong Companies Ordinance has a statutory duty to prepare a report to the members of the company on the company's financial statements.

"Present fairly, in all material respects" or "give a true and fair view"

A24. The phrases "present fairly, in all material respects," and "give a true and fair view" are regarded as being equivalent. Whether the phrase "present fairly, in all material respects," or the phrase "give a true and fair view" is used in any particular jurisdiction is determined by the law or regulation governing the audit of financial statements in that jurisdiction, or by generally accepted practice in that jurisdiction. Where law or regulation requires the use of different wording, this does not affect the requirement in paragraph 14 of this HKSA for the auditor to evaluate the fair presentation of financial statements prepared in accordance with a fair presentation framework.

A25. When the auditor expresses an unmodified opinion, it is not appropriate to use phrases such as "with the foregoing explanation" or "subject to" in relation to the opinion, as these suggest a conditional opinion or a weakening or modification of opinion.

Description of the financial statements and the matters they present

A26. The auditor's opinion covers the complete set of financial statements as defined by the applicable financial reporting framework. For example, in the case of many general purpose frameworks, the financial statements may include: a statement of financial position, a statement of comprehensive income, a statement of changes in equity, a statement of cash flows, and related notes, which ordinarily comprise a summary of significant accounting policies and other explanatory information. In some jurisdictions, additional information may also be considered to be an integral part of the financial statements.

A27. In the case of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion states that the financial statements present fairly, in all material respects, or give a true and fair view of, the matters that the financial statements are designed to present. For example, in the case of financial statements prepared in accordance with HKFRSs, these matters are *the financial position of the entity as at the end of the period and the entity's financial performance and cash flows for the period then ended*. Consequently, the […] in paragraph 25 and elsewhere in this HKSA is intended to be replaced by the words in italics in the preceding sentence when the applicable financial reporting framework is HKFRSs or, in the case of other applicable financial reporting frameworks, be replaced with words that describe the matters that the financial statements are designed to present.

Description of the applicable financial reporting framework and how it may affect the auditor's opinion

A28. The identification of the applicable financial reporting framework in the auditor's opinion is intended to advise users of the auditor's report of the context in which the auditor's opinion is expressed; it is not intended to limit the evaluation required in paragraph 14. The applicable financial reporting framework is identified in such terms as:

"… in accordance with Hong Kong Financial Reporting Standards" or

"… in accordance with accounting principles generally accepted in Jurisdiction X …"

A29. When the applicable financial reporting framework encompasses financial reporting standards and legal or regulatory requirements, the framework is identified in such terms as "… in accordance with Hong Kong Financial Reporting Standards and the requirements of Jurisdiction

X Corporations Act."[25b] HKSA 210 deals with circumstances where there are conflicts between the financial reporting standards and the legislative or regulatory requirements.[26]

A30. As indicated in paragraph A13, the financial statements may be prepared in accordance with two financial reporting frameworks, which are therefore both applicable financial reporting frameworks. Accordingly, each framework is considered separately when forming the auditor's opinion on the financial statements, and the auditor's opinion in accordance with paragraphs 25–27 refers to both frameworks as follows:

(a) If the financial statements comply with each of the frameworks individually, two opinions are expressed: that is, that the financial statements are prepared in accordance with one of the applicable financial reporting frameworks (e.g., HKFRSs) and an opinion that the financial statements are prepared in accordance with the other applicable financial reporting framework (e.g., IFRSs). These opinions may be expressed separately or in a single sentence (e.g., the financial statements are presented fairly, in all material respects […], in accordance with HKFRSs and IFRSs).

(b) If the financial statements comply with one of the frameworks but fail to comply with the other framework, an unmodified opinion can be given that the financial statements are prepared in accordance with the one framework (e.g., HKFRSs) but a modified opinion given with regard to the other framework in accordance with HKSA 705 (Revised).

A31. As indicated in paragraph A15, the financial statements may represent compliance with the applicable financial reporting framework and, in addition, disclose the extent of compliance with another financial reporting framework. Such supplementary information is covered by the auditor's opinion if it cannot be clearly differentiated from the financial statements (see paragraphs 53–54 and related application material in paragraphs A78–A84). Accordingly,

(a) If the disclosure as to the compliance with the other framework is misleading, a modified opinion is expressed in accordance with HKSA 705 (Revised).

(b) If the disclosure is not misleading, but the auditor judges it to be of such importance that it is fundamental to the users' understanding of the financial statements, an Emphasis of Matter paragraph is added in accordance with HKSA 706 (Revised), drawing attention to the disclosure.

Basis for Opinion (Ref: Para. 28)

A32. The Basis for Opinion section provides important context about the auditor's opinion. Accordingly, this HKSA requires the Basis for Opinion section to directly follow the Opinion section in the auditor's report.

A33. The reference to the standards used conveys to the users of the auditor's report that the audit has been conducted in accordance with established standards.

Relevant ethical requirements (Ref: Para. 28(c))

A34. The identification of the jurisdiction of origin of relevant ethical requirements increases transparency about those requirements relating to the particular audit engagement. HKSA 200 explains that relevant ethical requirements ordinarily comprise Parts A, B and D of

[25b] For companies incorporated in Hong Kong, the applicable Corporations Act is the Hong Kong Companies Ordinance.

[26] HKSA 210, paragraph 18

the Code related to an audit of financial statements.[27] When the relevant ethical requirements include those of the Code, the statement may also make reference to the Code. If the Code constitutes all of the ethical requirements relevant to the audit, the statement need not identify a jurisdiction of origin.

A35. In some jurisdictions, relevant ethical requirements may exist in several different sources, such as the ethical code(s) and additional rules and requirements within law and regulation. When the independence and other relevant ethical requirements are contained in a limited number of sources, the auditor may choose to name the relevant source(s) (e.g., the name of the code, rule or regulation applicable in the jurisdiction), or may refer to a term that is commonly understood and that appropriately summarizes those sources (e.g., independence requirements for audits of private entities in Jurisdiction X).

A36. Law or regulation, or the terms of an audit engagement may require the auditor to provide in the auditor's report more specific information about the sources of the relevant ethical requirements, including those pertaining to independence, that applied to the audit of the financial statements.

A37. In determining the appropriate amount of information to include in the auditor's report when there are multiple sources of relevant ethical requirements relating to the audit of the financial statements, an important consideration is balancing transparency against the risk of obscuring other useful information in the auditor's report.

Considerations specific to group audits

A38. In group audits when there are multiple sources of relevant ethical requirements, including those pertaining to independence, the reference in the auditor's report to the jurisdiction ordinarily relates to the relevant ethical requirements that are applicable to the group engagement team. This is because, in a group audit, component auditors are also subject to ethical requirements that are relevant to the group audit.[28]

A39. The HKSAs do not establish specific independence or ethical requirements for auditors, including component auditors, and thus do not extend, or otherwise override, the independence requirements of the Code or other ethical requirements to which the group engagement team is subject, nor do the HKSAs require that the component auditor in all cases to be subject to the same specific independence requirements that are applicable to the group engagement team. As a result, relevant ethical requirements, including those pertaining to independence, in a group audit situation may be complex. HKSA 600[29] provides guidance for auditors in performing work on the financial information of a component for a group audit, including those situations where the component auditor does not meet the independence requirements that are relevant to the group audit.

Key Audit Matters (Ref: Para. 31)

A40. Law or regulation may require communication of key audit matters for audits of entities other than listed entities, for example, entities characterized in such law or regulation as public interest entities.

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[27] HKSA 200, paragraph A16

[28] HKSA 600, paragraph A37

[29] HKSA 600, paragraphs 19–20

A41. The auditor may also decide to communicate key audit matters for other entities, including those that may be of significant public interest, for example, because they have a large number and wide range of stakeholders and considering the nature and size of the business. Examples of such entities may include financial institutions (such as banks, insurance companies, and pension funds), and other entities such as charities.

A42. HKSA 210 requires the auditor to agree the terms of the audit engagement with management and those charged with governance, as appropriate, and explains that the roles of management and those charged with governance in agreeing the terms of the audit engagement for the entity depend on the governance arrangements of the entity and relevant law or regulation.[30] HKSA 210 also requires the audit engagement letter or other suitable form of written agreement to include reference to the expected form and content of any reports to be issued by the auditor.[31] When the auditor is not otherwise required to communicate key audit matters, HKSA 210[32] explains that it may be helpful for the auditor to make reference in the terms of the audit engagement to the possibility of communicating key audit matters in the auditor's report and, in certain jurisdictions, it may be necessary for the auditor to include a reference to such possibility in order to retain the ability to do so.

Considerations specific to public sector entities

A43. Listed entities are not common in the public sector. However, public sector entities may be significant due to size, complexity or public interest aspects. In such cases, an auditor of a public sector entity may be required by law or regulation or may otherwise decide to communicate key audit matters in the auditor's report.

Responsibilities for the Financial Statements (Ref: Para. 33–34)

A44. HKSA 200 explains the premise, relating to the responsibilities of management and, where appropriate, those charged with governance, on which an audit in accordance with HKSAs is conducted.[33] Management and, where appropriate, those charged with governance, accept responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation. Management also accepts responsibility for such internal control as it determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. The description of management's responsibilities in the auditor's report includes reference to both responsibilities as it helps to explain to users the premise on which an audit is conducted. HKSA 260 (Revised) uses the term those charged with governance to describe the person(s) or organization(s) with responsibility for overseeing the entity, and provides a discussion about the diversity of governance structures across jurisdictions and by entity.

A45. There may be circumstances when it is appropriate for the auditor to add to the descriptions of the responsibilities of management and those charged with governance in paragraphs 34–35 to reflect additional responsibilities that are relevant to the preparation of the financial statements in the context of the particular jurisdiction or the nature of the entity.

[30] HKSA 210, paragraphs 9 and A22

[31] HKSA 210, paragraph 10

[32] HKSA 210, paragraph A25

[33] HKSA 200, paragraph 13(j)

A46. HKSA 210 requires the auditor to agree management's responsibilities in an engagement letter or other suitable form of written agreement.[34] HKSA 210 provides some flexibility in doing so, by explaining that, if law or regulation prescribes the responsibilities of management and, where appropriate, those charged with governance in relation to financial reporting, the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in HKSA 210. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the engagement letter or other suitable form of written agreement. In such cases, this wording may also be used in the auditor's report to describe the responsibilities as required by paragraph 34(a) of this HKSA. In other circumstances, including where the auditor decides not to use the wording of law or regulation as incorporated in the engagement letter, the wording in paragraph 34(a) of this HKSA is used. In addition to including the description of management's responsibilities in the auditor's report as required by paragraph 34, the auditor may refer to a more detailed description of these responsibilities by including a reference to where such information may be obtained (e.g., in the annual report of the entity or a website of an appropriate authority).

A47. In some jurisdictions, law or regulation prescribing management's responsibilities may specifically refer to a responsibility for the adequacy of accounting books and records, or accounting system. As books, records and systems are an integral part of internal control (as defined in HKSA 315 (Revised)[35]), the descriptions in HKSA 210 and in paragraph 34 do not make specific reference to them.

A48. The Appendix to this HKSA provides illustrations of how the requirement in paragraph 34(b) would be applied when HKFRSs is the applicable financial reporting framework. If an applicable financial reporting framework other than HKFRSs is used, the illustrative statements featured in the Appendix to this HKSA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

Oversight of the financial reporting process (Ref: Para. 35)

A49. When some, but not all, of the individuals involved in the oversight of the financial reporting process are also involved in preparing the financial statements, the description as required by paragraph 35 of this HKSA may need to be modified to appropriately reflect the particular circumstances of the entity. When individuals responsible for the oversight of the financial reporting process are the same as those responsible for the preparation of the financial statements, no reference to oversight responsibilities is required.

Auditor's Responsibilities for the Audit of the Financial Statements (Ref: Para. 37–40)

A50. The description of the auditor's responsibilities as required by paragraphs 37–40 of this HKSA may be tailored to reflect the specific nature of the entity, for example, when the auditor's report addresses consolidated financial statements. Illustration 2 in the Appendix to this HKSA includes an example of how this may be done.

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[34] HKSA 210, paragraph 6(b)(i)–(ii)

[35] HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 4(c)

Objectives of the auditor (Ref: Para. 38(a))

A51. The auditor's report explains that the objectives of the auditor are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes the auditor's opinion. These are in contrast to management's responsibilities for the preparation for the financial statements.

Description of materiality (Ref: Para. 38(c))

A52. The Appendix to this HKSA provides illustrations of how the requirement in paragraph 38(c), to provide a description of materiality, would be applied when HKFRSs is the applicable financial reporting framework. If an applicable financial reporting framework other than HKFRSs is used, the illustrative statements presented in the Appendix to this HKSA may need to be adapted to reflect the application of the other financial reporting framework in the circumstances.

Auditor's responsibilities relating to HKSA 701 (Ref: Para. 40(c))

A53. The auditor may also consider it useful to provide additional information in the description of the auditor's responsibilities beyond what is required by paragraph 40(c). For example, the auditor may make reference to the requirement in paragraph 9 of HKSA 701 to determine the matters that required significant auditor attention in performing the audit, taking into account areas of higher assessed risk of material misstatement or significant risks identified in accordance with HKSA 315 (Revised); significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and the effects on the audit of significant events or transactions that occurred during the period.

Location of the description of the auditor's responsibilities for the audit of the financial statements (Ref: Para. 41, 50(j))

A54. Including the information required by paragraphs 39–40 of this HKSA in an appendix to the auditor's report or, when law, regulation or HKSAs expressly permit, referring to a website of an appropriate authority containing such information may be a useful way of streamlining the content of the auditor's report. However, because the description of the auditor's responsibilities contains information that is necessary to inform users' expectations of an audit conducted in accordance with HKSAs, a reference is required to be included in the auditor's report indicating where such information can be accessed.

Location in an appendix (Ref: Para. 41(b), 50(j))

A55. Paragraph 41 permits the auditor to include the statements required by paragraphs 39–40 describing the auditor's responsibilities for the audit of the financial statements in an appendix to the auditor's report, provided that appropriate reference is made within the body of the auditor's report to the location of the appendix. The following is an illustration of how such a reference to an appendix could be made in the auditor's report:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is included in appendix X of this auditor's report. This description, which is located at [*indicate page number or other specific reference to the location of the description*], forms part of our auditor's report.

Reference to a website of an appropriate authority (Ref: Para. 41(c), 42)

A56. Paragraph 41 explains that the auditor may refer to a description of the auditor's responsibilities located on a website of an appropriate authority, only if expressly permitted by law, regulation or HKSAs. The information on the website that is incorporated in the auditor's report by way of a specific reference to the website location where such information can be found may describe the auditor's work, or the audit in accordance with HKSAs more broadly, but it cannot be inconsistent with the description required in paragraphs 39–40 of this HKSA. This means that the wording of the description of the auditor's responsibilities on the website may be more detailed, or may address other matters relating to an audit of financial statements, provided that such wording reflects and does not contradict the matters addressed in paragraphs 39–40.

A57. An appropriate authority could be a national auditing standard setter, regulator, or an audit oversight body.[35a] Such organizations are well-placed to ensure the accuracy, completeness and continued availability of the standardized information. It would not be appropriate for the auditor to maintain such a website. The following is an illustration of how such a reference to a website could be made in the auditor's report:

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

A further description of our responsibilities for the audit of the financial statements is located at [*Organization's*] website at: [*website address*]. This description forms part of our auditor's report.

Other Reporting Responsibilities (Ref: Para. 43–45)

A58. In some jurisdictions, the auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibilities under the HKSAs. For example, the auditor may be asked to report certain matters if they come to the auditor's attention during the course of the audit of the financial statements. Alternatively, the auditor may be asked to perform and report on additional specified procedures, or to express an opinion on specific matters, such as the adequacy of accounting books and records, internal control over financial reporting or other information. Auditing standards in the specific jurisdiction often provide

[35a] In Hong Kong, the Hong Kong Institute of Certified Public Accountants is the only statutory licensing body of accountants responsible for the professional training, development and regulation of the accountancy profession.

guidance on the auditor's responsibilities with respect to specific additional reporting responsibilities in that jurisdiction.

A59. In some cases, the relevant law or regulation may require or permit the auditor to report on these other responsibilities as part of their auditor's report on the financial statements. In other cases, the auditor may be required or permitted to report on them in a separate report.

A60. Paragraphs 43–45 of this HKSA permit combined presentation of other reporting responsibilities and the auditor's responsibilities under the HKSAs only when they address the same topics and the wording of the auditor's report clearly differentiates the other reporting responsibilities from those under the HKSAs. Such clear differentiation may make it necessary for the auditor's report to refer to the source of the other reporting responsibilities and to state that such responsibilities are beyond those required under the HKSAs. Otherwise, other reporting responsibilities are required to be addressed in a separate section in the auditor's report with a heading "Report on Other Legal and Regulatory Requirements," or otherwise as appropriate to the content of the section. In such cases, paragraph 44 requires the auditor to include reporting responsibilities under the HKSAs under a heading titled "Report on the Audit of the Financial Statements."

Name of the Engagement Partner (Ref: Para. 46)

A61. HKSQC 1[36] requires that the firm establish policies and procedures to provide reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements. Notwithstanding these HKSQC 1 requirements, naming the engagement partner in the auditor's report is intended to provide further transparency to the users of the auditor's report on financial statements of a listed entity.

A62. Law, regulation or HKSAs may require that the auditor's report include the name of the engagement partner responsible for audits other than those of financial statements of listed entities. The auditor may also be required by law, regulation or HKSAs, or may decide to include additional information beyond the engagement partner's name in the auditor's report to further identify the engagement partner, for example, the engagement partner's professional license number that is relevant to the jurisdiction where the auditor practices.

A63. In rare circumstances, the auditor may identify information or be subject to experiences that indicate the likelihood of a personal security threat that, if the identity of the engagement partner is made public, may result in physical harm to the engagement partner, other engagement team members or other closely related individuals. However, such a threat does not include, for example, threats of legal liability or legal, regulatory or professional sanctions. Discussions with those charged with governance about circumstances that may result in physical harm may provide additional information about the likelihood or severity of the significant personal security threat. Law, regulation or HKSAs may establish further requirements that are relevant to determining whether the disclosure of the name of the engagement partner may be omitted.

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[36] HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements,* paragraph 32

Signature of the Auditor (Ref: Para. 47)

A64. The auditor's signature is either in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction. In addition to the auditor's signature, in certain jurisdictions, the auditor may be required to declare in the auditor's report the auditor's professional accountancy designation or the fact that the auditor or firm, as appropriate, has been recognized by the appropriate licensing authority in that jurisdiction.[36a]

A65. In some cases, law or regulation may allow for the use of electronic signatures in the auditor's report.

Date of the Auditor's Report (Ref: Para. 49)

A66. The date of the auditor's report informs the user of the auditor's report that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor's responsibility for events and transactions after the date of the auditor's report is addressed in HKSA 560.[37]

A67. Since the auditor's opinion is provided on the financial statements and the financial statements are the responsibility of management, the auditor is not in a position to conclude that sufficient appropriate audit evidence has been obtained until evidence is obtained that all the statements and disclosures that comprise the financial statements have been prepared and management has accepted responsibility for them.

A68. In some jurisdictions, law or regulation identifies the individuals or bodies (e.g., the directors) that are responsible for concluding that all the statements and disclosures that comprise the financial statements have been prepared, and specifies the necessary approval process. In such cases, evidence is obtained of that approval before dating the report on the financial statements. In other jurisdictions, however, the approval process is not prescribed in law or regulation. In such cases, the procedures the entity follows in preparing and finalizing its financial statements in view of its management and governance structures are considered in order to identify the individuals or body with the authority to conclude that all the statements that comprise the financial statements, including the related notes, have been prepared. In some cases, law or regulation identifies the point in the financial statement reporting process at which the audit is expected to be complete.

[36a] According to section 409 of the Hong Kong Companies Ordinance required that an auditor's report must be signed –
(a) If the auditor is a natural person, by the auditor; or

(b) If the auditor is a firm or body corporate, by a natural person authorized to sign the auditor's name on the auditor's behalf.

In Hong Kong, the auditor's report is normally signed in the name of the firm because the firm as a whole assumes responsibility for the audit. To assist identification, the report will normally state the name of the firm of the auditor and the location of the auditor's office.

For a corporate practice, the auditor's report is signed by a director of the practice, who must be a professional accountant holding a current practising certificate. The auditor's report states the name of the corporate practice and the location of its office and is signed in the name of the corporate practice. The auditor's report also identifies the director responsible for the performance of the audit engagement contemplated by such report, and states his/her full name as appearing in his/her practising certificate and the practising certificate number.

For certain purposes, a printed copy of the auditor's report may be required to state the name of the auditor and be signed by the auditor (for example, the Hong Kong Inland Revenue Department normally requires a manuscript signed copy of the auditor's report). For published financial statements (e.g. those of listed companies) the auditor may sign the report in a form from which a final printed version is produced. In both these circumstances, the auditor may sign copies for identification purposes in order to provide appropriately signed auditor's reports, however, no further active procedures need be undertaken after the initial auditor's report has been signed.

[37] HKSA 560, *Subsequent Events*, paragraphs 10–17

A69. In some jurisdictions, final approval of the financial statements by shareholders is required before the financial statements are issued publicly. In these jurisdictions, final approval by shareholders is not necessary for the auditor to conclude that sufficient appropriate audit evidence has been obtained. The date of approval of the financial statements for purposes of HKSAs is the earlier date on which those with the recognized authority determine that all the statements and disclosures that comprise the financial statements have been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.[37a]

Auditor's Report Prescribed by Law or Regulation (Ref: Para. 50)

A70. HKSA 200 explains that the auditor may be required to comply with legal or regulatory requirements in addition to HKSAs.[38] When the differences between the legal or regulatory requirements and HKSAs relate only to the layout and wording of the auditor's report, the requirements in paragraph 50(a)–(o) set out the minimum elements to be included in the auditor's report to enable a reference to the Hong Kong Standards on Auditing. In those circumstances, the requirements in paragraphs 21–49 that are not included in paragraph 50(a)–(o) do not need to be applied including, for example, the required ordering of the Opinion and Basis for Opinion sections.

A71. Where specific requirements in a particular jurisdiction do not conflict with HKSAs, the layout and wording required by paragraphs 21–49 of this HKSA assist users of the auditor's report in more readily recognizing the auditor's report as a report of an audit conducted in accordance with HKSAs.

Information Required by HKSA 701 (Ref: Para. 50(h))

A72. Law or regulation may require the auditor to provide additional information about the audit that was performed, which may include information that is consistent with the objectives of HKSA 701, or may prescribe the nature and extent of communication about such matters.

A73. The HKSAs do not override law or regulation that governs an audit of financial statements. When HKSA 701 is applicable, reference can only be made to HKSAs in the auditor's report if, in applying the law or regulation, the section required by paragraph 50(h) of this HKSA is not inconsistent with the reporting requirements in HKSA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by HKSA 701, for example by:

- Modifying the heading "Key Audit Matters", if law or regulation prescribes a specific heading;
- Explaining why the information required by law or regulation is being provided in the auditor's report, for example by making a reference to the relevant law or regulation and describing how that information relates to the key audit matters;
- Where law or regulation prescribes the nature and extent of the description, supplementing the prescribed information to achieve an overall description of each key audit matter that is consistent with the requirement in paragraph 13 of HKSA 701.

[37a] In Hong Kong, the auditor would not date the auditor’s report earlier than the date on which the financial statements are approved by the directors. In practice, the date of the auditor’s report may be earlier than the date of physical signature of the auditor's report.

[38] HKSA 200, paragraph A57

A74. HKSA 210 deals with circumstances where law or regulation of the relevant jurisdiction prescribes the layout or wording of the auditor's report in terms that are significantly different from the requirements of HKSAs, which in particular includes the auditor's opinion. In these circumstances, HKSA 210 requires the auditor to evaluate:

(a) Whether users might misunderstand the assurance obtained from the audit of the financial statements and, if so,

(b) Whether additional explanation in the auditor's report can mitigate possible misunderstanding.

If the auditor concludes that additional explanation in the auditor's report cannot mitigate possible misunderstanding, HKSA 210 requires the auditor not to accept the audit engagement, unless required by law or regulation to do so. In accordance with HKSA 210, an audit conducted in accordance with such law or regulation does not comply with HKSAs. Accordingly, the auditor does not include any reference in the auditor's report to the audit having been conducted in accordance with Hong Kong Standards on Auditing.[39]

Considerations specific to public sector entities

A75. Auditors of public sector entities may also have the ability pursuant to law or regulation to report publicly on certain matters, either in the auditor's report or in a supplementary report, which may include information that is consistent with the objectives of HKSA 701. In such circumstances, the auditor may need to tailor certain aspects of the communication of key audit matters in the auditor's report required by HKSA 701 or include a reference in the auditor's report to a description of the matter in the supplementary report.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdiction and Hong Kong Standards on Auditing (Ref: Para. 51)

A76. The auditor may refer in the auditor's report to the audit having been conducted in accordance with both Hong Kong Standards on Auditing as well as the other auditing standards when, in addition to complying with the relevant other auditing standards, the auditor complies with each of the HKSAs relevant to the audit.[40]

A77. A reference to both Hong Kong Standards on Auditing and the other auditing standards is not appropriate if there is a conflict between the requirements in HKSAs and those in the other auditing standards that would lead the auditor to form a different opinion or not to include an Emphasis of Matter or Other Matter paragraph that, in the particular circumstances, is required by HKSAs. In such a case, the auditor's report refers only to the auditing standards (either Hong Kong Standards on Auditing or the other auditing standards) in accordance with which the auditor's report has been prepared.

Supplementary Information Presented with the Financial Statements (Ref: Para. 53–54)

A78. In some circumstances, the entity may be required by law, regulation or standards, or may voluntarily choose, to present together with the financial statements supplementary information that is not required by the applicable financial reporting framework. For example, supplementary information might be presented to enhance a user's understanding of the applicable financial reporting framework or to provide further explanation of specific financial

[39] HKSA 210, paragraph 21

[40] HKSA 200, paragraph A58

statement items. Such information is normally presented in either supplementary schedules or as additional notes.

A79. Paragraph 53 of this HKSA explains that the auditor's opinion covers supplementary information that is an integral part of the financial statements because of its nature or how it is presented. This evaluation is a matter of professional judgment. To illustrate:

- When the notes to the financial statements include an explanation or the reconciliation of the extent to which the financial statements comply with another financial reporting framework, the auditor may consider this to be supplementary information that cannot be clearly differentiated from the financial statements. The auditor's opinion would also cover notes or supplementary schedules that are cross-referenced from the financial statements.

- When an additional profit and loss account that discloses specific items of expenditure is disclosed as a separate schedule included as an Appendix to the financial statements, the auditor may consider this to be supplementary information that can be clearly differentiated from the financial statements.

A80. Supplementary information that is covered by the auditor's opinion does not need to be specifically referred to in the auditor's report when the reference to the notes in the description of the statements that comprise the financial statements in the auditor's report is sufficient.

A81. Law or regulation may not require that the supplementary information be audited, and management may decide to ask the auditor not to include the supplementary information within the scope of the audit of the financial statements.

A82. The auditor's evaluation whether unaudited supplementary information is presented in a manner that could be construed as being covered by the auditor's opinion includes, for example, where that information is presented in relation to the financial statements and any audited supplementary information, and whether it is clearly labeled as "unaudited."

A83. Management could change the presentation of unaudited supplementary information that could be construed as being covered by the auditor's opinion, for example, by:

- Removing any cross-references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited and unaudited information is sufficiently clear.

- Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum placing the unaudited notes together at the end of the required notes to the financial statements and clearly labeling them as unaudited. Unaudited notes that are intermingled with the audited notes can be misinterpreted as being audited.

A84. The fact that supplementary information is unaudited does not relieve the auditor of the responsibilities described in HKSA 720 (Revised).

Appendix

(Ref: Para. A19)

Illustrations of Independent Auditor's Reports on Financial Statements

- Illustration 1: An auditor's report for a listed entity incorporated in Hong Kong and where the financial statements are prepared in accordance with Hong Kong Financial Reporting Standards
- Illustration 2: An auditor's report for a listed entity incorporated in Hong Kong submitting consolidated financial statements and where the consolidated financial statements are prepared in accordance with Hong Kong Financial Reporting Standards
- Illustration 3: An auditor's report for an entity other than a listed entity incorporated in Hong Kong and where the financial statements are prepared in accordance with Hong Kong Financial Reporting Standards
- Illustration 4: An auditor's report for an entity other than a listed entity incorporated in Hong Kong submitting consolidated financial statements and where the consolidated financial statements are prepared in accordance with Hong Kong Financial Reporting Standards
- Illustration 5: An auditor's report for an entity other than a listed entity incorporated in Hong Kong and where the financial statements are prepared in accordance with Hong Kong Small and Medium-Sized Entity Financial Reporting Standard
- Illustration 6: An auditor's report for a listed entity incorporated overseas and reporting in Hong Kong
- Illustration 7: An auditor's report for an entity other than a listed entity incorporated in Hong Kong and where the financial statements are prepared in accordance with Hong Kong Financial Reporting Standard for Private Entities
- Illustration 8: An auditor's report for an entity other than a listed entity incorporated in Hong Kong submitting consolidated financial statements and where the consolidated financial statements are prepared in accordance with Hong Kong Financial Reporting Standard for Private Entities

Illustration 1 – Auditor's Report for a Listed Entity Incorporated in Hong Kong and where the Financial Statements are Prepared in Accordance with Hong Kong Financial Reporting Standards

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- Key audit matters have been communicated in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[1]

Report on the Audit of the Financial Statements[2]

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][3] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

1 In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

2 The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

3 HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

In our opinion, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[*Description of each key audit matter in accordance with HKSA 701.*]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[4]

The directors are responsible for the preparation of the financial statements that give a true and fair view in accordance with HKFRSs issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

[4] Throughout these illustrative auditor's reports, the terms directors and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[5] Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[6]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related

5 Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

6 This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.*][7]

The engagement partner on the audit resulting in this independent auditor's report is [*name*].

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

[7] For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, Appendix, Illustrations 3, 4 and 5.

Illustration 2 – Auditor's Report for a Listed Entity Incorporated in Hong Kong submitting Consolidated Financial Statements and where the Consolidated Financial Statements are Prepared in Accordance with Hong Kong Financial Reporting Standards

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is a group audit of an entity with subsidiaries (i.e., HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the consolidated financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- Key audit matters have been communicated in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[8]

Report on the Audit of the Consolidated Financial Statements[9]

Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries ("the Group") set out on pages …… to ……, which comprise the consolidated statement of financial position as at 31 December 20X1, and [the consolidated statement of profit or loss and][10] the consolidated statement of profit or loss and other comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

8 In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

9 The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

10 HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 20X1, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[*Description of each key audit matter in accordance with HKSA 701.*]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements[11]

The directors are responsible for the preparation of the consolidated financial statements that give a true and fair view in accordance with HKFRSs issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the directors are responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to

[11] Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

issue an auditor's report that includes our opinion.[12] Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.[13]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related

[12] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

[13] This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements.

safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics* as those *presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Consolidated Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Consolidated Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.*][14]

The engagement partner on the audit resulting in this independent auditor's report is [*name*].

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

[14] For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, Appendix, Illustrations 3, 4 and 5.

Illustration 3 – Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong and where the Financial Statements are Prepared in Accordance with Hong Kong Financial Reporting Standards

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[15]

Report on the Audit of the Financial Statements[16]

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][17] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

15 In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

16 The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

17 HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

In our opinion, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[18]

The directors are responsible for the preparation of the financial statements that give a true and fair view in accordance with HKFRSs issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[19] Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

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[18] Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

[19] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[20]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.*][21]

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[20] This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

[21] For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, Appendix, Illustrations 3, 4 and 5.

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

Illustration 4 – Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong submitting Consolidated Financial Statements and where the Consolidated Financial Statements are Prepared in Accordance with Hong Kong Financial Reporting Standards

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is a group audit of an entity with subsidiaries (i.e., HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the consolidated financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[22]

Report on the Audit of the Consolidated Financial Statements[23]

Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries ("the Group") set out on pages …… to ……, which comprise the consolidated statement of financial position as at 31 December 20X1, and [the consolidated statement of profit or loss and][24] the consolidated statement of profit or loss and other comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

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22 In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

23 The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

24 HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 20X1, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements[25]

The directors are responsible for the preparation of the consolidated financial statements that give a true and fair view in accordance with HKFRSs issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the directors are responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[26] Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the

[25] Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

[26] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.[27]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics* as those *presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Consolidated Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Consolidated Financial Statements section under the appropriate subheadings) provided that the wording*

[27] This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements.

in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.][28]

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

[28] For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, Appendix, Illustrations 3, 4 and 5.

Illustration 5 – Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong and where the Financial Statements are Prepared in Accordance with Hong Kong Small and Medium-Sized Entity Financial Reporting Standard

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Small and Medium-Sized Entity Financial Reporting Standard (SME-FRS). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with the SME-FRS (that is, a financial reporting framework, encompassing law or regulation, designed to meet the common financial information needs of a wide range of users, but which is not a fair presentation framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of SME Limited

(incorporated in Hong Kong with limited liability)[29]

Report on the Audit of the Financial Statements[30]

Opinion

We have audited the financial statements of SME Limited ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and the income statement [and cash flow statement][31] for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

[29] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[30] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[31] An entity which prepares and presents its financial statements in accordance with the SME-FRS is not required to include a cash flow statement in those financial statements. However, an entity may voluntarily include a cash flow statement in those financial statements.

In our opinion, the financial statements of the Company are prepared, in all material respects, in accordance with the Hong Kong Small and Medium-sized Entity Financial Reporting Standard ("SME-FRS") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") and with reference to Practice Note 900 (Revised) *Audit of Financial Statements Prepared in Accordance with the Small and Medium-sized Entity Financial Reporting Standard* issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[32]

The directors are responsible for the preparation of the financial statements in accordance with the SME-FRS issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[33] Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the

[32] Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

[33] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[34]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.*][35]

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[Date]

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[34] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

[35] For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*, Appendix, Illustrations 3, 4 and 5.

Illustration 6 – Auditor's Report for a Listed Entity Incorporated Overseas and reporting in Hong Kong

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit comprise the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants* together with the ethical requirements relating to the audit in the jurisdiction, and the auditor refers to both.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- Key audit matters have been communicated in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has reporting in Hong Kong.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company [or Other Appropriate Addressee]

(incorporated in [country or place] with limited liability)[36]

Report on the Audit of the Financial Statements[37]

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][38] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

36 In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

37 The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

38 HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

In our opinion, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA")[39] [and have been properly prepared in compliance with the disclosure requirements of the Hong Kong Companies Ordinance][40].

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code") together with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements and the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[*Description of each key audit matter in accordance with HKSA 701.*]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[41]

The directors are responsible for the preparation of the financial statements that give a true and fair view in accordance with HKFRSs issued by the HKICPA [and the disclosure requirements of the Hong Kong Companies Ordinance][45] and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern andusing the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

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[39] It may be necessary to refer to International Financial Reporting Standards or other national accounting standards and / or other national legal requirements depending on the jurisdiction in which the company is incorporated.

[40] For a company incorporated overseas and listed in Hong Kong, the disclosure requirements of the Hong Kong Companies Ordinance are applicable.

[41] Or other that are appropriate in the context of the legal framework in the particular jurisdiction.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[42] Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[43]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related

42 Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

43 This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.*]

The engagement partner on the audit resulting in this independent auditor's report is [*name*].

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

Illustration 7 – Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong and where the Financial Statements are Prepared in Accordance with Hong Kong Financial Reporting Standard for Private Entities

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using the Hong Kong Financial Reporting Standard for Private Entities (HKFRS for Private Entities). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with the HKFRS for Private Entities (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[44]

Report on the Audit of the Financial Statements[45]

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and the [[income statement][statement of comprehensive income][46], statement of changes in equity][statement of income and retained earnings][47] and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

[44] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[45] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[46] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[47] According to paragraph 3.18 of the HKFRS for Private Entities, the entity may present a single statement of income and retained earnings in place of the statement of comprehensive income and statement of changes in equity.

In our opinion, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standard for Private Entities ("HKFRS for Private Entities") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[48]

The directors are responsible for the preparation of the financial statements that give a true and fair view in accordance with HKFRS for Private Entities issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[49] Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

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48 Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

49 Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[50]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.*][51]

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[50] This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

[51] For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, Appendix, Illustrations 3, 4 and 5.

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

Illustration 8 – Auditor's Report for an Entity Other than a Listed Entity Incorporated in Hong Kong submitting Consolidated Financial Statements and where the Consolidated Financial Statements are Prepared in Accordance with Hong Kong Financial Reporting Standard for Private Entities

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standard for Private Entities (HKFRS for Private Entities). The audit is a group audit of an entity with subsidiaries (i.e., HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with HKFRS for Private Entities (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the consolidated financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- In addition to the audit of the consolidated financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[52]

Report on the Audit of the Consolidated Financial Statements[53]

Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries ("the Group") set out on pages …… to ……, which comprise the consolidated statement of financial position as at 31 December 20X1, and the consolidated [[income statement][statement of comprehensive income][54],

[52] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[53] The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

[54] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

consolidated statement of changes in equity][statement of income and retained earnings][55] and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 20X1, and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standard for Private Entities ("HKFRS for Private Entities") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*]

Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements[56]

The directors are responsible for the preparation of the consolidated financial statements that give a true and fair view in accordance with HKFRS for Private Entities issued by the HKICPA and the Hong Kong Companies Ordinance, and for such internal control as the directors determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the directors are responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[57] Reasonable assurance is a high level of

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[55] According to paragraph 3.18 of the HKFRS for Private Entities, the entity may present a single statement of income and retained earnings in place of the statement of comprehensive income and statement of changes in equity.

[56] Or other terms that are appropriate in the context of the legal framework of the particular jurisdiction

[57] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

Paragraph 41(b) of this HKSA explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.[58]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Report on Other Legal and Regulatory Requirements

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law or regulation. The matters addressed by other law or regulation (referred to as "other reporting responsibilities") shall be addressed within this*

[58] This sentence would be modified, as appropriate, in circumstances when the auditor also has a responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements.

section unless the other reporting responsibilities address the same topics as those *presented under the reporting responsibilities required by the HKSAs as part of the Report on the Audit of the Consolidated Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the HKSAs may be combined (i.e., included in the Report on the Audit of the Consolidated Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the HKSAs where such a difference exists.]*[59]

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

[59] For further guidance on non-compliance with the Hong Kong Companies Ordinance, refer to HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, Appendix, Illustrations 3, 4 and 5.

HKSA 701

Issued August 2015; revised June 2017

Effective for audits of financial statements
for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 701

Communicating Key Audit Matters in the Independent Auditor's Report

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

and may increase attention by management and those charged with governance to the disclosures in the financial statements to which reference is made in the auditor's report.

A4. HKSA 320[8] explains that it is reasonable for the auditor to assume that users of the financial statements:

(a) Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;

(b) Understand that the financial statements are prepared, presented and audited to levels of materiality;

(c) Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and

(d) Make reasonable economic decisions on the basis of the information in the financial statements.

Because the auditor's report accompanies the audited financial statements, the users of the auditor's report are considered to be the same as the intended users of the financial statements.

Relationship between Key Audit Matters, the Auditor's Opinion and Other Elements of the Auditor's Report (Ref: Para. 4, 12, 15)

A5. HKSA 700 (Revised) establishes requirements and provides guidance on forming an opinion on the financial statements.[9] Communicating key audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation. HKSA 705 (Revised) addresses circumstances in which the auditor concludes that there is a material misstatement relating to the appropriateness or adequacy of disclosures in the financial statements.[10]

A6. When the auditor expresses a qualified or adverse opinion in accordance with HKSA 705 (Revised), presenting the description of a matter giving rise to a modified opinion in the Basis for Qualified (Adverse) Opinion section helps to promote intended users' understanding and to identify such circumstances when they occur. Separating the communication of this matter from other key audit matters described in the Key Audit Matters section therefore gives it the appropriate prominence in the auditor's report (see paragraph 15). The Appendix in HKSA 705 (Revised) includes illustrative examples of how the introductory language in the Key Audit Matters section is affected when the auditor expresses a qualified or adverse opinion and other key audit matters are communicated in the auditor's report. Paragraph A58 of this HKSA illustrates how the Key Audit Matters section is presented when the auditor has determined that there are no other key audit matters to be communicated in the auditor's report beyond matters addressed in the Basis for Qualified (Adverse) Opinion section or Material Uncertainty Related to Going Concern section of the auditor's report.

[8] HKSA 320, *Materiality in Planning and Performing the Audit*, paragraph 4

[9] HKSA 700 (Revised), paragraphs 10–15 and A1–A15

[10] See paragraph A7 of HKSA 705 (Revised).

consideration of adverse consequences (e.g., such aspects may include harm to the entity's commercial negotiations or competitive position). However, management's views about the adverse consequences alone do not alleviate the need for the auditor to determine whether the adverse consequences would reasonably be expected to outweigh the public interest benefits of communication in accordance with paragraph 14(b).

- Highlighting whether there have been any communications with applicable regulatory, enforcement or supervisory authorities in relation to the matter, in particular whether such discussions would appear to support management's assertion as to why public disclosure about the matter is not appropriate.
- Enabling the auditor, where appropriate, to encourage management and those charged with governance to make public disclosure of relevant information about the matter. In particular, this may be possible if the concerns of management and those charged with governance about communicating are limited to specific aspects relating to the matter, such that certain information about the matter may be less sensitive and could be communicated.

The auditor also may consider it necessary to obtain a written representation from management as to why public disclosure about the matter is not appropriate, including management's view about the significance of the adverse consequences that may arise as a result of such communication.

A55. It may also be necessary for the auditor to consider the implications of communicating about a matter determined to be a key audit matter in light of relevant ethical requirements. In addition, the auditor may be required by law or regulation to communicate with applicable regulatory, enforcement or supervisory authorities in relation to the matter, regardless of whether the matter is communicated in the auditor's report. Such communication may also be useful to inform the auditor's consideration of the adverse consequences that may arise from communicating about the matter.

A56. The issues considered by the auditor regarding a decision to not communicate a matter are complex and involve significant auditor judgment. Accordingly, the auditor may consider it appropriate to obtain legal advice.

Form and Content of the Key Audit Matters Section in Other Circumstances (Ref: Para. 16)

A57. The requirement in paragraph 16 applies in three circumstances:

(a) The auditor determines in accordance with paragraph 10 that there are no key audit matters (see paragraph A59).

(b) The auditor determines in accordance with paragraph 14 that a key audit matter will not be communicated in the auditor's report and no other matters have been determined to be key audit matters.

(c) The only matters determined to be key audit matters are those communicated in accordance with paragraph 15.

HKSA 705 (Revised)

Issued August 2015; revised January 2016, August 2016, June 2017

Effective for audits of financial statements

for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 705 (Revised)

Modifications to the Opinion in the Independent Auditor's Report

Hong Kong Institute of

Certified Public Accountants

香港會計師公會

HONG KONG STANDARD ON AUDITING 705 (REVISED)
MODIFICATIONS TO THE OPINION IN THE INDEPENDENT AUDITOR'S REPORT

(Effective for audits of financial statements for periods ending on or after 15 December 2016)

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Hong Kong Standard on Auditing (HKSA) 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Basis for Opinion

20. When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by HKSA 700 (Revised): (Ref: Para. A21)

    (a) Amend the heading "Basis for Opinion" required by paragraph 28 of HKSA 700 (Revised) to "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate; and

    (b) Within this section, include a description of the matter giving rise to the modification.

21. If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the Basis for Opinion section a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in this section. (Ref: Para. A22)

22. If there is a material misstatement of the financial statements that relates to qualitative disclosures, the auditor shall include in the Basis for Opinion section an explanation of how the disclosures are misstated.

23. If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall:

    (a) Discuss the non-disclosure with those charged with governance;

    (b) Describe in the Basis for Opinion section the nature of the omitted information; and

    (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information. (Ref: Para. A23)

24. If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the Basis for Opinion section the reasons for that inability.

25. When the auditor expresses a qualified or adverse opinion, the auditor shall amend the statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion required by paragraph 28(d) of HKSA 700 (Revised) to include the word "qualified" or "adverse", as appropriate.

26. When the auditor disclaims an opinion on the financial statements, the auditor's report shall not include the elements required by paragraphs 28(b) and 28(d) of HKSA 700 (Revised). Those elements are:

    (a) A reference to the section of the auditor's report where the auditor's responsibilities are described; and

    (b) A statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

27. Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the Basis for Opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof. (Ref: Para. A24)

Description of Auditor's Responsibilities for the Audit of the Financial Statements When the Auditor Disclaims an Opinion on the Financial Statements

28. When the auditor disclaims an opinion on the financial statements due to an inability to obtain sufficient appropriate audit evidence, the auditor shall amend the description of the auditor's responsibilities required by paragraphs 39-41 of HKSA 700 (Revised) to include only the following: (Ref: Para. A25)

    (a) A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Hong Kong Standards on Auditing and to issue an auditor's report,

    (b) A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and

    (c) The statement about auditor independence and other ethical responsibilities required by paragraph 28(c) of HKSA 700 (Revised).

Considerations When the Auditor Disclaims an Opinion on the Financial Statements

29. Unless required by law or regulation, when the auditor disclaims an opinion on the financial statements, the auditor's report shall not include a Key Audit Matters section in accordance with HKSA 701 or an Other Information section in accordance with HKSA 720 (Revised).[4, 5] (Ref: Para. A26)

Communication with Those Charged with Governance

30. When the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances that led to the expected modification and the wording of the modification. (Ref: Para. A27)

Conformity and Compliance with International Standards on Auditing

31. As of August 2015 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report.* Compliance with the requirements of this HKSA ensures compliance with ISA 705 (Revised).

32. Additional local guidance is provided in Appendix.

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4 HKSA 701, Communicating Key Audit Matters in the Independent Auditor's Report, paragraphs 11-13

5 HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, paragraph A54

Application and Other Explanatory Material

Types of Modified Opinions (Ref: Para. 2)

A1. The table below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

Nature of Matter Giving Rise to the Modification	*Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements*	
	Material but Not Pervasive	*Material and Pervasive*
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Circumstances When a Modification to the Auditor's Opinion Is Required

Nature of Material Misstatements (Ref: Para. 6(a))

A2. HKSA 700 (Revised) requires the auditor, in order to form an opinion on the financial statements, to conclude as to whether reasonable assurance has been obtained about whether the financial statements as a whole are free from material misstatement.[6] This conclusion takes into account the auditor's evaluation of uncorrected misstatements, if any, on the financial statements in accordance with HKSA 450.[7]

A3. HKSA 450 defines a misstatement as a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Accordingly, a material misstatement of the financial statements may arise in relation to:

(a) The appropriateness of the selected accounting policies;

(b) The application of the selected accounting policies; or

(c) The appropriateness or adequacy of disclosures in the financial statements.

Appropriateness of the Selected Accounting Policies

A4. In relation to the appropriateness of the accounting policies management has selected, material misstatements of the financial statements may arise, for example, when:

(a) The selected accounting policies are not consistent with the applicable financial reporting framework; or

[6] HKSA 700 (Revised), paragraph 11

[7] HKSA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph 11

(b) The financial statements do not correctly describe an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows; or

(c) The financial statements do not represent or disclose the underlying transactions and events in a manner that achieves fair presentation.

A5. Financial reporting frameworks often contain requirements for the accounting for, and disclosure of, changes in accounting policies. Where the entity has changed its selection of significant accounting policies, a material misstatement of the financial statements may arise when the entity has not complied with these requirements.

Application of the Selected Accounting Policies

A6. In relation to the application of the selected accounting policies, material misstatements of the financial statements may arise:

(a) When management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application); or

(b) Due to the method of application of the selected accounting policies (such as an unintentional error in application).

Appropriateness or Adequacy of Disclosures in the Financial Statements

A7. In relation to the appropriateness or adequacy of disclosures in the financial statements, material misstatements of the financial statements may arise when:

(a) The financial statements do not include all of the disclosures required by the applicable financial reporting framework;

(b) The disclosures in the financial statements are not presented in accordance with the applicable financial reporting framework; or

(c) The financial statements do not provide the additional disclosures necessary to achieve fair presentation beyond disclosures specifically required by the applicable financial reporting framework.

Paragraph A17 of HKSA 450 provides further examples of material misstatements in qualitative disclosures that may arise.

Nature of an Inability to Obtain Sufficient Appropriate Audit Evidence (Ref: Para. 6(b))

A8. The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

(a) Circumstances beyond the control of the entity;

(b) Circumstances relating to the nature or timing of the auditor's work; or

(c) Limitations imposed by management.

A9. An inability to perform a specific procedure does not constitute a limitation on the scope of the audit if the auditor is able to obtain sufficient appropriate audit evidence by performing alternative procedures. If this is not possible, the requirements of paragraphs 7(b) and 9–10 apply as appropriate. Limitations imposed by management may have other implications for the audit, such as for the auditor's assessment of fraud risks and consideration of engagement continuance.

A10. Examples of circumstances beyond the control of the entity include when:

- The entity's accounting records have been destroyed.
- The accounting records of a significant component have been seized indefinitely by governmental authorities.

A11. Examples of circumstances relating to the nature or timing of the auditor's work include when:

- The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied.
- The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
- The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

A12. Examples of an inability to obtain sufficient appropriate audit evidence arising from a limitation on the scope of the audit imposed by management include when:

- Management prevents the auditor from observing the counting of the physical inventory.
- Management prevents the auditor from requesting external confirmation of specific account balances.

Determining the Type of Modification to the Auditor's Opinion

Consequence of an Inability to Obtain Sufficient Appropriate Audit Evidence Due to a Management-Imposed Limitation after the Auditor Has Accepted the Engagement (Ref: Para. 13(b)(i)–14)

A13. The practicality of withdrawing from the audit may depend on the stage of completion of the engagement at the time that management imposes the scope limitation. If the auditor has substantially completed the audit, the auditor may decide to complete the audit to the extent possible, disclaim an opinion and explain the scope limitation within the Basis for Disclaimer of Opinion section prior to withdrawing.

A14. In certain circumstances, withdrawal from the audit may not be possible if the auditor is required by law or regulation to continue the audit engagement. This may be the case for an auditor that is appointed to audit the financial statements of public sector entities. It may also be the case in jurisdictions where the auditor is appointed to audit the financial statements covering a specific period, or appointed for a specific period and is prohibited from withdrawing before the completion of the audit of those financial statements or before the end of that period, respectively. The auditor may also consider it necessary to include an Other Matter paragraph in the auditor's report.[8]

A15. When the auditor concludes that withdrawal from the audit is necessary because of a scope limitation, there may be a professional, legal or regulatory requirement for the auditor to communicate matters relating to the withdrawal from the engagement to regulators or the entity's owners.

Other Considerations Relating to an Adverse Opinion or Disclaimer of Opinion (Ref: Para. 15)

A16. The following are examples of reporting circumstances that would not contradict the auditor's adverse opinion or disclaimer of opinion:

- The expression of an unmodified opinion on financial statements prepared under a given financial reporting framework and, within the same report, the expression of an adverse opinion on the same financial statements under a different financial reporting framework.[9]

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8 HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph A10

9 See paragraph A31 of HKSA 700 (Revised) for a description of this circumstance.

Appendix

(Ref: Para. A17–A18, A25)

Illustrations of Independent Auditor's Reports with Modifications to the Opinion

- Illustration 1: An auditor's report containing a qualified opinion due to a material misstatement of the financial statements.
- Illustration 2: An auditor's report containing an adverse opinion due to a material misstatement of the consolidated financial statements.
- Illustration 3: An auditor's report containing a qualified opinion due to the auditor's inability to obtain sufficient appropriate audit evidence regarding a foreign associate.
- Illustration 4: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements.
- Illustration 5: An auditor's report containing a disclaimer of opinion due to the auditor's inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements.

Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements [8]

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 2 in HKSA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 2 in HKSA 700 (Revised).*]

Report on Other Matters under sections 407(2)[8a] and 407(3)[8a] of the Hong Kong Companies Ordinance[8b]

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a foreign associate as described in the *Basis for Qualified Opinion* section of our report above:

- we were unable to determine whether adequate accounting records had been kept; and
- we have not obtained all the information or explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

The engagement partner on the audit resulting in this independent auditor's report is [*name*].

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

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[8] Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

[8a] Section 407 of the CO requires the auditor to opine on other matters:

(1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
  (a) whether adequate accounting records have been kept by the company; and
  (b) whether the financial statements are in agreement with the accounting records.
(2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
  (a) adequate accounting records have not been kept by the company; or
  (b) the financial statements are not in agreement with the accounting records in any material respect.
(3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.
(4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

[8b] For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 (Revised), *Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)*.

Illustration 4 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about a Single Element of the Consolidated Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of consolidated financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is a group audit of an entity with subsidiaries (i.e., HKSA 600 applies).
- The consolidated financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the consolidated financial statements in HKSA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about a single element of the consolidated financial statements. That is, the auditor was also unable to obtain audit evidence about the financial information of a joint venture investment that represents over 90% of the entity's net assets. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the consolidated financial statements (i.e., a disclaimer of opinion is appropriate).
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- The auditor has obtained all of the other information prior to the date of the auditor's report.
- Those responsible for oversight of the consolidated financial statements differ from those responsible for the preparation of the consolidated financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the consolidated financial statements, the auditor has no other reporting responsibilities required under local law except for the Hong Kong Companies Ordinance.
- The information in the directors' report is not inconsistent with the consolidated financial statements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[8c]

Report on the Audit of the Consolidated Financial Statements [9]

Disclaimer of Opinion

We were engaged to audit the consolidated financial statements of ABC Company and its subsidiaries ("the Group") set out on pages …… to ……, which comprise the consolidated statement of financial position as at 31 December 20X1, and [the consolidated statement of profit or loss and][9a] the consolidated statement of profit or loss and other comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial

[8c] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[9] Not used.

[9a] HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

statements, including a summary of significant accounting policies.

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

Basis for Disclaimer of Opinion

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

Responsibilities of Directors and Those Charged with Governance for the Consolidated Financial Statements[10]

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 4 in HKSA 700 (Revised).]*

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our responsibility is to conduct an audit of the Group's consolidated financial statements in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and to issue an auditor's report.[10a] However, because of the matter described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these consolidated financial statements.

We are independent of the Group in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code.

[10] Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

[10a] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Report on Other Matters under sections 407(2)[10b] and 407(3)[10b] of the Hong Kong Companies Ordinance[10c]

In respect alone of the inability to obtain sufficient appropriate audit evidence regarding an investment in a joint venture as described in the *Basis for Disclaimer of Opinion* section of our report above:

- we were unable to determine whether adequate accounting records had been kept; and
- we have not obtained all the information or explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants [Auditor Address]

[*Date*]

[10b] Section 407 of the CO requires the auditor to opine on other matters:

(1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
  (a) whether adequate accounting records have been kept by the company; and
  (b) whether the financial statements are in agreement with the accounting records.

(2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
  (a) adequate accounting records have not been kept by the company; or
  (b) the financial statements are not in agreement with the accounting records in any material respect.

(3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.

(4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

[10c] For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 (Revised), *Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)*.

Illustration 5 – Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600, does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor was unable to obtain sufficient appropriate audit evidence about multiple elements of the financial statements, that is, the auditor was also unable to obtain audit evidence about the entity's inventories and accounts receivable. The possible effects of this inability to obtain sufficient appropriate audit evidence are deemed to be both material and pervasive to the financial statements.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- The auditor has obtained all of the other information prior to the date of the auditor's report.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- A more limited description of the auditor's responsibilities section is required.
- In addition to the audit of the financial statements, the auditor has no other reporting responsibilities required under local law except for the Hong Kong Companies Ordinance.
- The information in the directors' report is not inconsistent with the financial statements.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[10d]

Report on the Audit of the Financial Statements[11]

Disclaimer of Opinion

We were engaged to audit the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][11a] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

[10d] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[11] Not used.

[11a] HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

We do not express an opinion on the financial statements of the Company. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements. In all other respects, in our opinion the financial statements have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after 31 December 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at 31 December 20X0 and 20X1, which are stated in the statements of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at 31 December 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up [the statement of profit or loss and][11a] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows.

Responsibilities of Directors and Those Charged with Governance for the Financial Statements [12]

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the Company's financial statements in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and to issue an auditor's report.[12a] However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code.

---

[12] Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction

[12a] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Report on Other Matters under sections 407(2)[12b] and 407(3)[12b] of the Hong Kong Companies Ordinance[12c]

In respect alone of the inability to obtain sufficient appropriate audit evidence about the inventories and accounts receivable as described in the *Basis for Disclaimer of Opinion* section of our report above:

- we were unable to determine whether adequate accounting records had been kept; and
- we have not obtained all the information or explanations that, to the best of our knowledge and belief, are necessary and material for the purpose of the audit.

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants

[*Auditor Address*]

[*Date*]

[12b] Section 407 of the CO requires the auditor to opine on other matters:

(1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
  (a) whether adequate accounting records have been kept by the company; and
  (b) whether the financial statements are in agreement with the accounting records.

(2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
  (a) adequate accounting records have not been kept by the company; or
  (b) the financial statements are not in agreement with the accounting records in any material respect.

(3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.

(4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

Where the opinion on the financial statements has been modified, the auditor needs to evaluate what the consequences of this modification are on the reporting requirement under the CO, and further modify the report if necessary.

[12c] For the requirements under the Hong Kong Companies Ordinance, reference may be made to PN 600.1 (Revised), *Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)*.

HKSA 706 (Revised)
Issued August 2015; revised August 2016, June 2017

Effective for audits of financial statements
for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 706 (Revised)

Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

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

HONG KONG STANDARD ON AUDITING 706 (REVISED) EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS IN THE INDEPENDENT AUDITOR'S REPORT

(Effective for audits of financial statements for periods ending on or after 15 December 2016)

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Appendix 1: List of HKSAs Containing Requirements for Emphasis of Matter Paragraphs

Appendix 2: List of HKSAs Containing Requirements for Other Matter Paragraphs

Appendix 3: Illustration of an Independent Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

Appendix 4: Illustration of an Independent Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

Hong Kong Standard on Auditing (HKSA) 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

11. When the auditor includes an Other Matter paragraph in the auditor's report, the auditor shall include the paragraph within a separate section with the heading "Other Matter," or other appropriate heading. (Ref: Para. A15–A17)

Communication with Those Charged with Governance

12. If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the wording of this paragraph. (Ref: Para. A18)

Conformity and Compliance with International Standards on Auditing

13. As of August 2015 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. Compliance with the requirements of this HKSA ensures compliance with ISA 706 (Revised).

14. Additional local explanation and guidance is provided in Appendices 3 and 4.

***

Application and Other Explanatory Material

The Relationship between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report (Ref: Para. 2, 8(b))

A1. Key audit matters are defined in HKSA 701 as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance, which include significant findings from the audit of the financial statements of the current period.[5] Communicating key audit matters provides additional information to intended users of the financial statements to assist them in understanding those matters that, in the auditor's professional judgment, were of most significance in the audit and may also assist them in understanding the entity and areas of significant management judgment in the audited financial statements. When HKSA 701 applies, the use of Emphasis of Matter paragraphs is not a substitute for a description of individual key audit matters.

A2. Matters that are determined to be key audit matters in accordance with HKSA 701 may also be, in the auditor's judgment, fundamental to users' understanding of the financial statements. In such cases, in communicating the matter as a key audit matter in accordance with HKSA 701, the auditor may wish to highlight or draw further attention to its relative importance. The auditor may do so by presenting the matter more prominently than other matters in the Key Audit Matters section (e.g., as the first matter) or by including additional information in the description of the key audit matter to indicate the importance of the matter to users' understanding of the financial statements.

[5] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16

(c) Reporting in accordance with HKSA 570 (Revised)[8] when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

A8. Paragraphs A16–A17 provide further guidance on the placement of Emphasis of Matter paragraphs in particular circumstances.

Other Matter Paragraphs in the Auditor's Report (Ref: Para. 10–11)

Circumstances in Which an Other Matter Paragraph May Be Necessary

Relevant to Users' Understanding of the Audit

A9. HKSA 260 (Revised) requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit, which includes communication about the significant risks identified by the auditor.[9] Although matters relating to significant risks may be determined to be key audit matters, other planning and scoping matters (e.g., the planned scope of the audit, or the application of materiality in the context of the audit) are unlikely to be key audit matters because of how key audit matters are defined in HKSA 701. However, law or regulation may require the auditor to communicate about planning and scoping matters in the auditor's report, or the auditor may consider it necessary to communicate about such matters in an Other Matter paragraph.

A10. In the rare circumstance where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive,[10] the auditor may consider it necessary to include an Other Matter paragraph in the auditor's report to explain why it is not possible for the auditor to withdraw from the engagement.

Relevant to Users' Understanding of the Auditor's Responsibilities or the Auditor's Report

A11. Law, regulation or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon. When the Other Matter section includes more than one matter that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report, it may be helpful to use different sub-headings for each matter.

A12. An Other Matter paragraph does not deal with circumstances where the auditor has other reporting responsibilities that are in addition to the auditor's responsibility under the HKSAs (see Other Reporting Responsibilities section in HKSA 700 (Revised)[11]), or where the auditor has been asked to perform and report on additional specified procedures, or to express an opinion on specific matters.

[8] HKSA 570 (Revised), paragraphs 22–23

[9] HKSA 260 (Revised), paragraph 15

[10] See paragraph 13(b)(ii) of HKSA 705 (Revised) for a discussion of this circumstance.

[11] HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 43–44

Appendix 3

(Ref: Para. A17)

Illustration of an Independent Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600[1] does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- Key audit matters have been communicated in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Corresponding figures are presented, and the prior period's financial statements were audited by a predecessor auditor. The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and has decided to do so.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[1a]

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

[1a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

Appendix 4

(Ref: Para. A8)

Illustration of an Independent Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors responsibility for the financial statements in HKSA 210.
- A departure from the applicable financial reporting framework resulted in a qualified opinion.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- Between the date of the financial statements and the date of the auditor's report, there was a fire in the entity's production facilities, which was disclosed by the entity as a subsequent event. In the auditor's judgment, the matter is of such importance that it is fundamental to users' understanding of the financial statements. The matter did not require significant auditor attention in the audit of the financial statements in the current period.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has not obtained any other information prior to the date of the auditor's report.[4a]
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[4b]

[4a] Normally for an entity incorporated in Hong Kong, the auditor should have obtained the directors' report prior to the date of the auditor's report. Under section 406(2) of the Hong Kong Companies Ordinance, the auditor is required to state in the auditor's report if the auditor is of the opinion that the information in a directors' report is not consistent with the financial statements. The auditor should refer to HKSA 720 (Revised) for guidance.

[4b] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

HKSA 710
Issued September 2009; revised July 2010,
June 2014, August 2015, June 2017

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

Hong Kong Standard on Auditing 710

Comparative Information—Corresponding Figures and Comparative Financial Statements

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

HONG KONG STANDARD ON AUDITING 710

COMPARATIVE INFORMATION— CORRESPONDING FIGURES AND COMPARATIVE FINANCIAL STATEMENTS

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

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Hong Kong Standard on Auditing (HKSA) 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*, should be read in conjunction with HKSA 200, Overall *Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to comparative information in an audit of financial statements. When the financial statements of the prior period have been audited by a predecessor auditor or were not audited, the requirements and guidance in HKSA 510[1] regarding opening balances also apply.

The Nature of Comparative Information

2. The nature of the comparative information that is presented in an entity's financial statements depends on the requirements of the applicable financial reporting framework. There are two different broad approaches to the auditor's reporting responsibilities in respect of such comparative information: corresponding figures and comparative financial statements. The approach to be adopted is often specified by law or regulation but may also be specified in the terms of engagement.

3. The essential audit reporting differences between the approaches are:

   (a) For corresponding figures [1a], the auditor's opinion on the financial statements refers to the current period only; whereas

   (b) For comparative financial statements, the auditor's opinion refers to each period for which financial statements are presented.

   This HKSA addresses separately the auditor's reporting requirements for each approach.

Effective Date

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

Objectives

5. The objectives of the auditor are:

   (a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and

   (b) To report in accordance with the auditor's reporting responsibilities.

Definitions

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

   (a) Comparative information – The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework.

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[1] HKSA 510, *Initial Audit Engagements—Opening Balances*

[1a] Additional local guidance is provided in Appendix 2.

(b) Corresponding figures – Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as “current period figures”). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

(c) Comparative financial statements – Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period.

For purposes of this HKSA, references to "prior period" should be read as "prior periods" when the comparative information includes amounts and disclosures for more than one period.

Requirements

Audit Procedures

7. The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether:

   (a) The comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and

   (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.

8. If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period’s financial statements, the auditor shall also follow the relevant requirements of HKSA 560.[2] If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.

9. As required by HKSA 580,[3] the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information. (Ref: Para. A1)

Audit Reporting

Corresponding Figures

10. When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the circumstances described in paragraphs 11, 12, and 14. (Ref: Para. A2)

[2] HKSA 560, *Subsequent Events*, paragraphs 14-17

[3] HKSA 580, *Written Representations*, paragraph 14

11. If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

    (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or

    (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures. (Ref: Para. A3-A5)

12. If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein. (Ref: Para. A6)

Prior Period Financial Statements Audited by a Predecessor Auditor

13. If the financial statements of the prior period were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report:

    (a) That the financial statements of the prior period were audited by the predecessor auditor;

    (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and

    (c) The date of that report. (Ref: Para. A7)

Prior Period Financial Statements Not Audited

14. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.[4] (Ref: Para. A8)

Comparative Financial Statements

15. When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. (Ref: Para. A9-A10)

[4] HKSA 510, paragraph 6

16. When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with HKSA 706 (Revised).[5] (Ref: Para. A11)

Prior Period Financial Statements Audited by a Predecessor Auditor

17. If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph:

    (a) that the financial statements of the prior period were audited by a predecessor auditor;

    (b) the type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and

    (c) the date of that report,

    unless the predecessor auditor's report on the prior period's financial statements is reissued with the financial statements.

18. If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and, unless all of those charged with governance are involved in managing the entity,[6] those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period. (Ref: Para. A12)

Prior Period Financial Statements Not Audited

19. If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.[7] (Ref: Para. A13)

Conformity and Compliance with International Standards on Auditing

20. As of September 2009 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 710, *Comparative Information Corresponding Figures and Comparative Financial Statements*. Compliance with the requirements of this HKSA ensures compliance with ISA 710.

21. Additional local guidance is provided in footnote 1a and Appendices 1 and 2.

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[5] HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, paragraph 8

[6] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 13

[7] HKSA 510, paragraph 6

Application and Other Explanatory Material

Audit Procedures

Written Representations (Ref: Para. 9)

A1. In the case of comparative financial statements, the written representations are requested for all periods referred to in the auditor's opinion because management needs to reaffirm that the written representations it previously made with respect to the prior period remain appropriate. In the case of corresponding figures, the written representations are requested for the financial statements of the current period only because the auditor's opinion is on those financial statements, which include the corresponding figures. However, the auditor requests a specific written representation regarding any restatement made to correct a material misstatement in the prior period financial statements that affect the comparative information.

Audit Reporting

Corresponding Figures

No Reference in Auditor's Opinion (Ref: Para. 10)

A2. The auditor's opinion does not refer to the corresponding figures because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.

Modification in Auditor's Report on the Prior Period Unresolved (Ref: Para. 11)

A3. When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

A4. When the auditor's opinion on the prior period, as previously expressed, was modified, the unresolved matter that gave rise to the modification may not be relevant to the current period figures. Nevertheless, a qualified opinion, a disclaimer of opinion, or an adverse opinion (as applicable) may be required on the current period's financial statements because of the effects or possible effects of the unresolved matter on the comparability of the current and corresponding figures.

A5. Illustrative examples of the auditor's report if the auditor's report on the prior period included a modified opinion and the matter giving rise to the modification is unresolved are contained in Illustrations 1 and 2 of the Appendix 1.

Misstatement in Prior Period Financial Statements (Ref: Para. 12)

A6. When the prior period financial statements that are misstated have not been amended and an auditor's report has not been reissued, but the corresponding figures have been properly restated or appropriate disclosures have been made in the current period financial statements, the auditor's report may include an Emphasis of Matter paragraph describing the circumstances and referring to where relevant disclosures that fully describe the matter can be found in the financial statements (see HKSA 706 (Revised)).

Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 13)

A7. An illustrative example of the auditor's report if the prior period financial statements were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures is contained in Illustration 3 of the Appendix 1.

Prior Period Financial Statements Not Audited (Ref: Para. 14)

A8 If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor is required by HKSA 705 (Revised)[8] to express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with HKSA 705 (Revised). If the auditor encountered significant difficulty in obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements, the auditor may determine this to be a key audit matter in accordance with HKSA 701.[9]

Comparative Financial Statements

Reference in Auditor's Opinion (Ref: Para. 15)

A9. Because the auditor's report on comparative financial statements applies to the financial statements for each of the periods presented, the auditor may express a qualified opinion or an adverse opinion, disclaim an opinion, or include an Emphasis of Matter paragraph with respect to one or more periods, while expressing a different auditor's opinion on the financial statements of the other period.

A10. An illustrative example of the auditor's report if the auditor is required to report on both the current and the prior period financial statements in connection with the current year's audit and the prior period included a modified opinion and the matter giving rise to the modification is unresolved, is contained in Illustration 4 of the Appendix 1.

Opinion on Prior Period Financial Statements Different from Previous Opinion (Ref: Para. 16)

A11. When reporting on the prior period financial statements in connection with the current period's audit, the opinion expressed on the prior period financial statements may be different from the opinion previously expressed if the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period. In some jurisdictions, the auditor may have additional reporting responsibilities designed to prevent future reliance on the auditor's previously issued report on the prior period financial statements.

Prior Period Financial Statements Audited by a Predecessor Auditor (Ref: Para. 18)

A12. The predecessor auditor may be unable or unwilling to reissue the auditor's report on the prior period financial statements. An Other Matter paragraph of the auditor's report may indicate that the predecessor auditor reported on the financial statements of the prior period before amendment. In addition, if the auditor is engaged to audit and obtains sufficient appropriate audit evidence to be satisfied as to the appropriateness of the amendment, the auditor's report may also include the following paragraph:

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[8] HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

[9] HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

> As part of our audit of the 20X2 financial statements, we also audited the adjustments described in Note X that were applied to amend the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied. We were not engaged to audit, review, or apply any procedures to the 20X1 financial statements of the company other than with respect to the adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 20X1 financial statements taken as a whole.

Prior Period Financial Statements Not Audited (Ref: Para. 19)

A13. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor is required by HKSA 705 (Revised) to express a qualified opinion or disclaim an opinion on the financial statements, as appropriate, in accordance with HKSA 705 (Revised). If the auditor encountered significant difficulty in obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements, the auditor may determine this to be a key audit matter in accordance with HKSA 701.

Appendix 1

(Ref: Para. A5, A7, A10)

Illustrations of Independent Auditors' Reports

Illustration 1 - Corresponding Figures

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600[1] does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.[2]
- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are material and require a modification to the auditor's opinion regarding the current period figures.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).[3]
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has not obtained any other information prior to the date of the auditor's report.[3a]
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

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

[2] HKSA 210, *Agreeing the Terms of Audit Engagements*

[3] HKSA 570 (Revised), *Going Concern*

[3a] Under section 406(2) of the Hong Kong Companies Ordinance, the auditor is required to state in the auditor's report if the auditor is of the opinion that the information in a directors' report is not consistent with the financial statements. In this regard, the auditor refers to HKSA 720 (Revised) for guidance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[3b]

Report on the Audit of the Financial Statements[4]

Qualified Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][4a] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which constitutes a departure from HKFRSs. This is the result of a decision taken by the directors at the start of the preceding financial year and caused us to qualify our audit opinion on the financial statements relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 20X1 and xxx in 20X0, property, plant and equipment should be reduced by accumulated depreciation of xxx in 20X1 and xxx in 20X0, and the accumulated loss should be increased by xxx in 20X1 and xxx in 20X0.

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

3b In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

4 The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

4a HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[5]

[*Reporting in accordance with HKSA 700 (Revised)[6] – see Illustration 3 in HKSA 700 (Revised*).]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[*Auditor's Address*]

[*Date*]

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5 Throughout these illustrative auditor's reports, the terms directors and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

6 HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Illustration 2 - Corresponding Figures

For purposes of this illustrative auditor's report the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are immaterial but require a modification to the auditor's opinion because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has not obtained any other information prior to the date of the auditor's report.[6a]
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[6b]

Report on the Audit of the Financial Statements[7]

[6a] Under section 406(2) of the Hong Kong Companies Ordinance, the auditor is required to state in the auditor's report if the auditor is of the opinion that the information in a directors' report is not consistent with the financial statements. In this regard, the auditor refers to HKSA 720 (Revised) for guidance.

[6b] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[7] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

Qualified Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][7a] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects on the corresponding figures of the matter described in the *Basis for Qualified Opinion* section of our report, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Qualified Opinion

Because we were appointed auditors of the Company during 20X0, we were not able to observe the counting of the physical inventories at the beginning of that period or satisfy ourselves concerning those inventory quantities by alternative means. Since opening inventories affect the determination of the results of operations, we were unable to determine whether adjustments to the results of operations and opening retained earnings might be necessary for 20X0. Our audit opinion on the financial statements for the period ended 31 December 20X0 was modified accordingly. Our opinion on the current period's financial statements is also modified because of the possible effect of this matter on the comparability of the current period's figures and the corresponding figures.

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[8]

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

7a HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

8 Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised)*.]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[*Auditor's Address*]

[*Date*]

Illustration 3 - Corresponding Figures

For purposes of this illustrative auditor's report the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by the directors of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of the directors' responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Corresponding figures are presented, the prior period's financial statements were audited by a predecessor auditor.
- The auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law in addition to the Hong Kong Companies Ordinance.

INDEPENDENT AUDITOR'S REPORT

To the Members of ABC Company

(incorporated in Hong Kong with limited liability)[8a]

Report on the Audit of the Financial Statements[9]

[8a] In Hong Kong, it is a common practice to disclose the place of incorporation of the company.

[9] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statement of financial position as at 31 December 20X1, and [the statement of profit or loss and][9a] the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1, and of its financial performance and its cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the Hong Kong Companies Ordinance.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Other Matter

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

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon"]

[*Reporting in accordance with the reporting requirements in HKSA 720 (Revised) – see Illustration 1 in Appendix 2 of HKSA 720 (Revised).*][10]

Responsibilities of Directors and Those Charged with Governance for the Financial Statements [11]

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

9a HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

10 HKSA720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

11 Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[*Auditor's Address*]

[*Date*]

Illustration 4 - Comparative Financial Statements[11a]

For purposes of this illustrative auditor's report the following circumstances are assumed:

- Audit of a complete set of financial statements of an entity other than a listed entity using Hong Kong Financial Reporting Standards (HKFRSs). The audit is not a group audit (i.e., HKSA 600 does not apply).
- The financial statements are prepared by management of the entity in accordance with HKFRSs (a general purpose framework).
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.
- The auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year's audit.
- The auditor's report on the prior period, as previously issued, included a qualified opinion.
- The matter giving rise to the modification is unresolved.
- The effects or possible effects of the matter on the current period's figures are material to both the current period financial statements and prior period financial statements and require a modification to the auditor's opinion.
- The relevant ethical requirements that apply to the audit are those of the jurisdiction.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701.
- The auditor has not obtained any other information prior to the date of the auditor's report.
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- In addition to the audit of the financial statements, the auditor has other reporting responsibilities required under local law.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements[12]

[11a] The comparative financial statements as presented in this Illustration are not generally applicable to an audit performed on a Hong Kong incorporated company's annual statutory financial statements, refer to Appendix 2.

[12] The sub-title "Report on the Audit of the Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

Qualified Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the statements of financial position as at 31 December 20X1 and 20X0, and [the statement of profit or loss and][12a] the statements of profit or loss and other comprehensive income, statements of changes in equity and statements of cash flows for the years then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the financial statements give a true and fair view of the financial position of the Company as at 31 December 20X1 and 20X0 and of its financial performance and its cash flows for the years then ended in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA").

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which constitutes a departure from HKFRSs. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 20X1 and xxx in 20X0, property, plant and equipment should be reduced by accumulated depreciation of xxx in 20X1 and xxx in 20X0, and the accumulated loss should be increased by xxx in 20X1 and xxx in 20X0.

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the HKICPA. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements[13]

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

[12a] HKAS 1 allows entities to present comprehensive income using either a one statement approach (i.e. a single "statement of profit or loss and other comprehensive income") or a two-statement approach (i.e. a "statement of profit or loss" together with a "statement of profit or loss and other comprehensive income"). Different terms may be used as long as they are consistent with the titles of the corresponding statements.

[13] Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 3 in HKSA 700 (Revised*).]

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[*Auditor's Address*]

[*Date*]

Appendix 2

(Ref: Para. 3(a))

Additional Local Guidance on Corresponding Figures

In Hong Kong the corresponding figures method of presentation as described in paragraph 3(a) is used.

(a) Financial statements of companies incorporated under the provisions of the Companies Ordinance are required to disclose comparative amounts as required under the applicable accounting standards.

(b) Appendix 16 to the Main Board Rules and Chapter 18.07(5) of the GEM Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Ltd. require financial statements of listed issuers to include comparative figures for the balance sheet, income statement, cash flow statement and statement of changes in equity for the corresponding previous period.

(c) "Comparative figures" referred to by the Main Board Rules and GEM Rules refers to the corresponding figures as described in this HKSA.

The auditor's consideration of comparative financial statements as described in paragraphs 3(b), 15-19 and A9-A13 is, therefore, not generally applicable to an audit performed on a Hong Kong incorporated company's annual statutory financial statements in accordance with HKSAs.

HKSA 720 (Revised)

Issued August 2015; revised August 2016, June 2017

Effective for audits of financial statements

for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 720 (Revised)

The Auditor's Responsibilities Relating to Other Information

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

Appendix 1: Examples of Amounts or Other Items that May be Included in the Other Information

Appendix 2: Illustrations of Independent Auditor's Reports Relating to Other Information

Appendix 3: Additional Local Guidance on Requirements of the Hong Kong Companies Ordinance

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Hong Kong Standard on Auditing (HKSA) 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Conformity and Compliance with International Standards on Auditing

26. As of August 2015 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*. Compliance with the requirements of this HKSA ensures compliance with ISA 720 (Revised).

27. Additional local guidance is provided in footnote 2a, 2b, 3a and 4a, Appendices 2 and 3.

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Application and Other Explanatory Material

Definitions

Annual Report (Ref: Para. 12(a))

A1. Law, regulation or custom may define the content of an annual report, and the name by which it is to be referred, for entities in a particular jurisdiction; however, the content and the name may vary within a jurisdiction and from one jurisdiction to another.

A2. An annual report is typically prepared on an annual basis. However, when the financial statements being audited are prepared for a period less than or more than a year, an annual report may also be prepared that covers the same period as the financial statements.

A3. In some cases, an entity's annual report may be a single document and referred to by the title "annual report" or by some other title. In other cases, law, regulation or custom may require the entity to report to owners (or similar stakeholders) information on the entity's operations and the entity's financial results and financial position as set out in the financial statements (i.e., an annual report) by way of a single document, or by way of two or more separate documents that in combination serve the same purpose. For example, depending on law, regulation or custom in a particular jurisdiction, one or more of the following documents may form part of the annual report:

- Management report, management commentary, or operating and financial review or similar reports by those charged with governance (for example, a directors' report[4a]).
- Chairman's statement.
- Corporate governance statement.
- Internal control and risk assessment reports.

A4. An annual report may be made available to users in printed form, or electronically, including on the entity's website. A document (or combination of documents) may meet the definition of an annual report, irrespective of the manner in which it is made available to users.

A5. An annual report is different in nature, purpose and content from other reports, such as a report prepared to meet the information needs of a specific stakeholder group or a report prepared to comply with a specific regulatory reporting objective (even when such a report is required to be publicly available). Examples of reports that, when issued as standalone documents, are not typically part of the combination of documents that comprise an annual report (subject to law,

[4a] According to Schedule 5 of the Hong Kong Companies Ordinance, a director's report of a company incorporated in Hong Kong must contain a business review unless it satisfies the conditions as set out in section 388(3).

voluntary report to stakeholders) but management is unable to confirm to the auditor the purpose or timing of such a document. If the auditor is unable to ascertain the purpose or timing of such a document, the document is not considered other information for purposes of this HKSA.

A18. Obtaining the other information in a timely manner prior to the date of the auditor's report enables any revisions that are found to be necessary to be made to the financial statements, the auditor's report, or the other information prior to their issuance. The audit engagement letter[6] may make reference to an agreement with management to make available to the auditor the other information in a timely manner, and if possible prior to the date of the auditor's report.

A19. When other information is only made available to users via the entity's website, the version of the other information obtained from the entity, rather than directly from the entity's website, is the relevant document on which the auditor would perform procedures in accordance with this HKSA. The auditor has no responsibility under this HKSA to search for other information, including other information that may be on the entity's website, nor to perform any procedures to confirm that other information is appropriately displayed on the entity's website or otherwise has been appropriately transmitted or displayed electronically.

A20. The auditor is not precluded from dating or issuing the auditor's report if the auditor has not obtained some or all of the other information.

A21. When the other information is obtained after the date of the auditor's report, the auditor is not required to update the procedures performed in accordance with paragraphs 6 and 7 of HKSA 560.[7]

A22. HKSA 580[8] establishes requirements and provides guidance on the use of written representations. The written representation required to be requested by paragraph 13(c) regarding other information that will be available only after the date of the auditor's report is intended to support the auditor's ability to complete the procedures required by this HKSA with respect to such information. In addition, the auditor may find it useful to request other written representations, for example, that:

- Management has informed the auditor of all the documents that it expects to issue that may comprise other information;
- The financial statements and any other information obtained by the auditor prior to the date of the auditor's report are consistent with one another, and the other information does not contain any material misstatements; and
- With regard to other information that has not been obtained by the auditor prior to the date of the auditor's report, that management intends to prepare and issue such other information and the expected timing of such issuance.

Reading and Considering the Other Information (Ref: Para. 14–15)

A23. The auditor is required by HKSA 200[9] to plan and perform the audit with professional skepticism. Maintaining professional skepticism when reading and considering the other information includes, for example, recognizing that management may be overly optimistic about the success of its plans, and being alert to information that may be inconsistent with:

6 HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraph A24

7 HKSA 560, *Subsequent Events*

8 HKSA 580, *Written Representations*

9 HKSA 200, paragraph 15

Reporting Prescribed by Law or Regulation (Ref: Para. 24)

A59. HKSA 200[16] explains that the auditor may be required to comply with legal or regulatory requirements in addition to the HKSAs. Where this is the case, the auditor may be obliged to use a specific layout or wording in the auditor's report that differs from that described in this HKSA. Consistency in the auditor's report, when the audit has been conducted in accordance with HKSAs, promotes credibility in the global marketplace by making more readily identifiable those audits that have been conducted in accordance with globally recognized standards. When the differences between the legal or regulatory requirements to report with respect to the other information and this HKSA relate only to the layout and wording in the auditor's report and, at a minimum, each of the elements identified in paragraph 24 is included in the auditor's report, the auditor's report may refer to Hong Kong Standards on Auditing. Accordingly, in such circumstances the auditor is considered to have complied with the requirements of this HKSA, even when the layout and wording used in the auditor's report are specified by legal or regulatory reporting requirements.

[16] HKSA 200, paragraph A57

Appendix 2

(Ref: Para. 21–22, A53)

Illustrations of Independent Auditor's Reports Relating to Other Information

- Illustration 1: An auditor's report of any entity, whether listed or other than listed, containing an unmodified opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and has not identified a material misstatement of the other information.
- Illustration 2: An auditor's report of a listed entity containing an unmodified opinion when the auditor has obtained part of the other information prior to the date of the auditor's report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor's report.
- Illustration 3: An auditor's report of an entity other than a listed entity containing an unmodified opinion when the auditor has obtained part of the other information prior to the date of the auditor's report, has not identified a material misstatement of the other information, and expects to obtain other information after the date of the auditor's report.
- Illustration 4: An auditor's report of a listed entity containing an unmodified opinion when the auditor has obtained no other information prior to the date of the auditor's report but expects to obtain other information after the date of the auditor's report.
- Illustration 5: An auditor's report of any entity, whether listed or other than listed, containing an unmodified opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and has concluded that a material misstatement of the other information exists.
- Illustration 6: An auditor's report of any entity, whether listed or other than listed, containing a qualified opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and there is a limitation of scope with respect to a material item in the consolidated financial statements which also affects the other information.
- Illustration 7: An auditor's report of any entity, whether listed or other than listed, containing an adverse opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and the adverse opinion on the consolidated financial statements also affects the other information.
- Illustration 8: An auditor's report of any entity incorporated in Hong Kong, whether listed or other than listed, containing an unmodified opinion when the auditor has obtained all of the other information prior to the date of the auditor's report and has concluded that a material misstatement of the other information exists and has identified an inconsistency between the information in the directors' report and the financial statements.

misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Directors and Those Charged with Governance for the Financial Statements[8]

[*Reporting in accordance with HKSA 700 (Revised)*[9] *– see Illustration 1 or 3 in HKSA 700 (Revised).*]

Auditor's Responsibilities for the Audit of the Financial Statements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 1 or 3 in HKSA 700 (Revised).*]

Report on Other Legal and Regulatory Requirements

[*Reporting in accordance with HKSA 700 (Revised) – see Illustration 1 or 3 in HKSA 700 (Revised).*]

[The engagement partner on the audit resulting in this independent auditor's report is [*name*].[10]]

XYZ & Co.

Certified Public Accountants (Practising) or Certified Public Accountants [*Auditor Address*]

[*Date*]

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8 Throughout these illustrative auditor's reports, the terms directors/ management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction

9 HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

10 The name of the engagement partner is included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat (see HKSA 700 (Revised), paragraph 46).

HKSA 800 (Revised)

Issued August 2016; revised June 2017

Effective for audits of financial statements
for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 800 (Revised)

Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

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HONG KONG STANDARD ON AUDITING 800 (REVISED)

SPECIAL CONSIDERATIONS—AUDITS OF FINANCIAL STATEMENTS PREPARED IN ACCORDANCE WITH SPECIAL PURPOSE FRAMEWORKS

(Effective for audits of financial statements for periods ending on or after 15 December 2016)

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Hong Kong Standard on Auditing (HKSA) 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks,* should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. The Hong Kong Standards on Auditing (HKSAs) in the 100-700 series apply to an audit of financial statements. This HKSA deals with special considerations in the application of those HKSAs to an audit of financial statements prepared in accordance with a special purpose framework.

2. This HKSA is written in the context of a complete set of financial statements prepared in accordance with a special purpose framework. HKSA 805 (Revised)[1] deals with special considerations relevant to an audit of a single financial statement or of a specific element, account or item of a financial statement.

3. This HKSA does not override the requirements of the other HKSAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

Effective Date

4. This HKSA is effective for audits of financial statements for periods ending on or after 15 December 2016.

Objective

5. The objective of the auditor, when applying HKSAs in an audit of financial statements prepared in accordance with a special purpose framework, is to address appropriately the special considerations that are relevant to:

   (a) The acceptance of the engagement;

   (b) The planning and performance of that engagement; and

   (c) Forming an opinion and reporting on the financial statements.

Definitions

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

   (a) Special purpose financial statements – Financial statements prepared in accordance with a special purpose framework.[1a] (Ref: Para. A4)

   (b) Special purpose framework – A financial reporting framework designed to meet the financial information needs of specific users. The financial reporting framework may be a fair presentation framework or a compliance framework.[2] (Ref: Para. A1-A4)

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[1] HKSA 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*

[1a] Special purpose financial statements are prepared in accordance with a framework other than a general purpose framework.

[2] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 13(a)

7. Reference to "financial statements" in this HKSA means "a complete set of special purpose financial statements." The requirements of the applicable financial reporting framework determine the presentation, structure, and content of the financial statements, and what constitutes a complete set of financial statements. Reference to "special purpose financial statements" includes the related disclosures.

Requirements

Considerations When Accepting the Engagement

Acceptability of the Financial Reporting Framework

8. HKSA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements.[3] In an audit of special purpose financial statements, the auditor shall obtain an understanding of: (Ref: Para. A5-A8)

   (a) The purpose for which the financial statements are prepared;

   (b) The intended users; and

   (c) The steps taken by management to determine that the applicable financial reporting framework is acceptable in the circumstances.

Considerations When Planning and Performing the Audit

9. HKSA 200 requires the auditor to comply with all HKSAs relevant to the audit.[4] In planning and performing an audit of special purpose financial statements, the auditor shall determine whether application of the HKSAs requires special consideration in the circumstances of the engagement. (Ref: Para. A9-A12)

10. HKSA 315 (Revised) requires the auditor to obtain an understanding of the entity's selection and application of accounting policies.[5] In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall obtain an understanding of any significant interpretations of the contract that management made in the preparation of those financial statements. An interpretation is significant when adoption of another reasonable interpretation would have produced a material difference in the information presented in the financial statements.

Forming an Opinion and Reporting Considerations

11. When forming an opinion and reporting on special purpose financial statements, the auditor shall apply the requirements in HKSA 700 (Revised).[6] (Ref: Para. A13–A19)

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[3] HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

[4] HKSA 200, paragraph 18

[5] HKSA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph 11(c)

[6] HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Description of the Applicable Financial Reporting Framework

12. HKSA 700 (Revised) requires the auditor to evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.[7] In the case of financial statements prepared in accordance with the provisions of a contract, the auditor shall evaluate whether the financial statements adequately describe any significant interpretations of the contract on which the financial statements are based.

13. HKSA 700 (Revised) deals with the form and content of the auditor's report, including the specific ordering for certain elements. In the case of an auditor's report on special purpose financial statements:

    (a) The auditor's report shall also describe the purpose for which the financial statements are prepared and, if necessary, the intended users, or refer to a note in the special purpose financial statements that contains that information; and

    (b) If management has a choice of financial reporting frameworks in the preparation of such financial statements, the explanation of management's[8] responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework

14. The auditor's report on special purpose financial statements shall include an Emphasis of Matter paragraph alerting users of the auditor's report that the financial statements are prepared in accordance with a special purpose framework and that, as a result, the financial statements may not be suitable for another purpose. (Ref: Para. A20-A21)

Conformity and Compliance with International Standards on Auditing

15. As of August 2016 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*. Compliance with the requirements of this HKSA ensures compliance with ISA 800 (Revised).

16. Additional local explanations and guidance are provided in footnote 1a and Appendix.

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Application and Other Explanatory Material

Definition of Special Purpose Framework (Ref: Para. 6)

A1. Examples of special purpose frameworks are:

- A tax basis of accounting for a set of financial statements that accompany an entity's tax return;
- The cash receipts and disbursements basis of accounting for cash flow information that an entity may be requested to prepare for creditors;

[7] HKSA 700 (Revised), paragraph 15

[8] Or other term that is appropriate in the context of the legal framework in the particular jurisdiction

stakeholders. In some jurisdictions, law or regulation may prescribe the financial reporting framework to be used by management in the preparation of special purpose financial statements for a certain type of entity. For example, a regulator may establish financial reporting provisions to meet the requirements of that regulator. In the absence of indications to the contrary, such a financial reporting framework is presumed acceptable for special purpose financial statements prepared by such entity.

A7. Where the financial reporting standards referred to in paragraph A6 are supplemented by legislative or regulatory requirements, HKSA 210 requires the auditor to determine whether any conflicts between the financial reporting standards and the additional requirements exist, and prescribes actions to be taken by the auditor if such conflicts exist.[10]

A8. The applicable financial reporting framework may encompass the financial reporting provisions of a contract, or sources other than those described in paragraphs A6 and A7. In that case, the acceptability of the financial reporting framework in the circumstances of the engagement is determined by considering whether the framework exhibits attributes normally exhibited by acceptable financial reporting frameworks as described in Appendix 2 of HKSA 210. In the case of a special purpose framework, the relative importance to a particular engagement of each of the attributes normally exhibited by acceptable financial reporting frameworks is a matter of professional judgment. For example, for purposes of establishing the value of net assets of an entity at the date of its sale, the vendor and the purchaser may have agreed that very prudent estimates of allowances for uncollectible accounts receivable are appropriate for their needs, even though such financial information is not neutral when compared with financial information prepared in accordance with a general purpose framework.

Considerations When Planning and Performing the Audit (Ref: Para. 9)

A9. HKSA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all HKSAs relevant to the audit. It also requires the auditor to comply with each requirement of an HKSA unless, in the circumstances of the audit, the entire HKSA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an HKSA by performing alternative audit procedures to achieve the aim of that requirement.[11]

A10. Application of some of the requirements of the HKSAs in an audit of special purpose financial statements may require special consideration by the auditor. For example, in HKSA 320, judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group.[12] In the case of an audit of special purpose financial statements, however, those judgments are based on a consideration of the financial information needs of the intended users.

A11. In the case of special purpose financial statements, such as those prepared in accordance with the requirements of a contract, management may agree with the intended users on a threshold below which misstatements identified during the audit will not be corrected or otherwise adjusted. The existence of such a threshold does not relieve the auditor from the requirement to determine materiality in accordance with HKSA 320 for purposes of planning and performing the audit of the special purpose financial statements.

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[10] HKSA 210, paragraph 18

[11] HKSA 200, paragraphs 14, 18, and 22-23

[12] HKSA 320, *Materiality in Planning and Performing an Audit*, paragraph 2

A12. HKSA 260 (Revised) requires the auditor to determine the appropriate person(s) within the entity's governance structure with whom to communicate.[13] HKSA 260 (Revised) notes that, in some cases, all of those charged with governance are involved in managing the entity, and the application of the communication requirements is modified to recognize this position.[14] When a complete set of general purpose financial statements is also prepared by the entity, those person(s) responsible for the oversight of the preparation of the special purpose financial statements may not be the same as those charged with governance responsible for the oversight of the preparation of those general purpose financial statements.

Forming an Opinion and Reporting Considerations (Ref: Para. 11)

A13. The Appendix to this HKSA contains illustrations of independent auditor's reports on special purpose financial statements. Other illustrations of auditor's reports may be relevant to reporting on special purpose financial statements (see for example, the Appendices to HKSA 700 (Revised), HKSA 705 (Revised),[15] HKSA 570 (Revised),[16] HKSA 720 (Revised),[17] and HKSA 706 (Revised)).[18]

Application of HKSA 700 (Revised) When Reporting on Special Purpose Financial Statements

A14. Paragraph 11 of this HKSA explains that the auditor is required to apply HKSA 700 (Revised) when forming an opinion and reporting on special purpose financial statements. In doing so, the auditor is also required to apply the reporting requirements in other HKSAs and may find the special considerations addressed in paragraphs A15–A19 below helpful.

Going Concern

A15. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis of accounting is relevant (e.g., the going concern basis of accounting is not relevant for some financial statements prepared on a tax basis in particular jurisdictions).[19] Depending on the applicable financial reporting framework used in the preparation of the special purpose financial statements, the description in the auditor's report of management's responsibilities[20] relating to going concern may need to be adapted as necessary. The description in the auditor's report of the auditor's responsibilities[21] may also need to be adapted as necessary depending on how HKSA 570 (Revised) applies in the circumstances of the engagement.

Key Audit Matters

A16. HKSA 700 (Revised) requires the auditor to communicate key audit matters in accordance with HKSA 701[22] for audits of complete sets of general purpose financial statements of listed entities. For audits of special purpose financial statements, HKSA 701 only applies when

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13 HKSA 260 (Revised), *Communication with Those Charged with Governance*

14 HKSA 260 (Revised), paragraph A8

15 HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

16 HKSA 570 (Revised), *Going Concern*

17 HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*

18 HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

19 HKSA 570 (Revised), paragraph 2

20 See HKSA 700 (Revised), paragraphs 34(b) and A48.

21 See HKSA 700 (Revised), paragraph 39(b)(iv).

22 HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

communication of key audit matters in the auditor's report on the special purpose financial statements is required by law or regulation or the auditor otherwise decides to communicate key audit matters. When key audit matters are communicated in the auditor's report on special purpose financial statements, HKSA 701 applies in its entirety.[23]

Other Information

A17. HKSA 720 (Revised) deals with the auditor's responsibilities relating to other information. In the context of this HKSA, reports containing or accompanying the special purpose financial statements—the purpose of which is to provide owners (or similar stakeholders) with information on matters presented in the special purpose financial statements—are considered to be annual reports for the purpose of HKSA 720 (Revised). In the case of financial statements prepared using a special purpose framework, the term "similar stakeholders" includes the specific users whose financial information needs are met by the design of the special purpose framework used to prepare the special purpose financial statements. When the auditor determines that the entity plans to issue such a report, the requirements in HKSA 720 (Revised) apply to the audit of the special purpose financial statements.

Name of the Engagement Partner

A18. The requirement in HKSA 700 (Revised) for the auditor to include the name of the engagement partner in the auditor's report also applies to audits of special purpose financial statements of listed entities.[24] The auditor may be required by law or regulation to include the name of the engagement partner in the auditor's report or may otherwise decide to do so when reporting on special purpose financial statements of entities other than listed entities.

Inclusion of a Reference to the Auditor's Report on the Complete Set of General Purpose Financial Statements

A19. The auditor may deem it appropriate to refer, in an Other Matter paragraph in the auditor's report on the special purpose financial statements, to the auditor's report on the complete set of general purpose financial statements or to matter(s) reported therein (see HKSA 706 (Revised)).[25]For example, the auditor may consider it appropriate to refer in the auditor's report on the special purpose financial statements to a Material Uncertainty Related to Going Concern section included in the auditor's report on the complete set of general purpose financial statements.

Alerting Readers that the Financial Statements Are Prepared in Accordance with a Special Purpose Framework (Ref: Para. 14)

A20. The special purpose financial statements may be used for purposes other than those for which they were intended. For example, a regulator may require certain entities to place the special purpose financial statements on public record. To avoid misunderstandings, the auditor alerts users of the auditor's report by including an Emphasis of Matter paragraph explaining that the financial statements are prepared in accordance with a special purpose framework and, therefore, may not be suitable for another purpose. HKSA 706 (Revised) requires this paragraph to be included within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter".[26]

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[23] HKSA 700 (Revised), paragraph 31

[24] See HKSA 700 (Revised), paragraphs 46 and A56–A58.

[25] See HKSA 706 (Revised), paragraphs 10–11.

[26] See paragraph 9(a) of HKSA 706 (Revised).

<u>Illustration 3: An auditor's report on a complete set of financial statements of a listed entity prepared in accordance with the financial reporting provisions established by a regulator (for purposes of this illustration, a fair presentation framework).</u>

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a complete set of financial statements of a listed entity that have been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator (that is, a special purpose framework) to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.
- The applicable financial reporting framework is a fair presentation framework.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised). The disclosure of the material uncertainty in the financial statements is adequate.
- Distribution or use of the auditor's report is not restricted.
- The auditor is required by the regulator to communicate key audit matters in accordance with HKSA 701.
- The Other Matter paragraph refers to the fact that the auditor has also issued an auditor's report on financial statements prepared by ABC Company for the same period in according with a general purpose framework.
- The auditor has determined that there is no other information (i.e., the requirements of HKSA 720 (Revised) do not apply).
- Those responsible for oversight of the financial statements differ from those responsible for the preparation of the financial statements.
- The auditor has no other reporting responsibilities required under local law or regulation.

INDEPENDENT AUDITOR'S REPORT

[To the Shareholders of ABC Company or Appropriate Addressee]

Opinion

We have audited the financial statements of ABC Company ("the Company") set out on pages …… to ……, which comprise the [balance sheet][statement of financial position][4a] as at 31 December 20X1, and the [income statement][statement of comprehensive income][4a], statement of changes in equity and [cash flow statement][statement of cash flows][4a] for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at 31 December 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with the financial reporting provisions of Section Y of Regulation Z.

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter - Basis of Accounting

We draw attention to Note X to the financial statements, which describes the basis of accounting. The financial statements are prepared to assist the Company to meet the requirements of Regulator DEF. As a result, the financial statements may not be suitable for another purpose.[4b] Our opinion is not modified in respect of this matter.

Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the year ended 31 December 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter**.**

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the Material Uncertainty Related to Going Concern section above, we have determined the matters described below to be key audit matters to be communicated in our report.

[*Description of each key audit matter in accordance with HKSA 701 as applied to this audit.*]

[4a] Delete as appropriate, different terms may be used as long as they are consistent with the titles of the corresponding statements.

[4b] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Other Matter

The Company has prepared a separate set of financial statements for the year ended 31 December 20X1 in accordance with Hong Kong Financial Reporting Standards on which we issued a separate auditor's report to the shareholders of the Company dated 31 March 20X2.

Responsibilities of Management and Those Charged with Governance for the Financial Statements[5]

Management is responsible for the preparation and fair presentation of the financial statements in accordance with the financial reporting provisions of Section Y of Regulation Z[6] and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

Paragraph 41(b) of HKSA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of HKSA 700 (Revised) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

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5 Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

6 Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of financial statements that give a true and fair view in accordance with the financial reporting provisions of section Y of Regulation Z, and for such …"

- Obtain an understanding of internal control relevant to audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[7]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is [*name*].

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor address]

[Date]

[7] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements.

HKSA 805 (Revised)
Issued August 2016; revised June 2017

Effective for audits for periods
ending on or after 15 December 2016

Hong Kong Standard on Auditing 805 (Revised)

Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement

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

HONG KONG STANDARD ON AUDITING 805 (REVISED)

SPECIAL CONSIDERATIONS—AUDITS OF SINGLE FINANCIAL STATEMENTS AND SPECIFIC ELEMENTS, ACCOUNTS OR ITEMS OF A FINANCIAL STATEMENT

(Effective for audits for periods ending on or after 15 December 2016)

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Hong Kong Standard on Auditing (HKSA) 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. The Hong Kong Standards on Auditing (HKSAs) in the 100-700 series apply to an audit of financial statements and are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. This HKSA deals with special considerations in the application of those HKSAs to an audit of a single financial statement or of a specific element, account or item of a financial statement. The single financial statement or the specific element, account or item of a financial statement may be prepared in accordance with a general or special purpose framework. If prepared in accordance with a special purpose framework, HKSA 800 (Revised)[1] also applies to the audit. (Ref: Para. A1-A4)

2. This HKSA does not apply to the report of a component auditor, issued as a result of work performed on the financial information of a component at the request of a group engagement team for purposes of an audit of group financial statements (see HKSA 600[2]).

3. This HKSA does not override the requirements of the other HKSAs; nor does it purport to deal with all special considerations that may be relevant in the circumstances of the engagement.

Effective Date

4. This HKSA is effective for audits of single financial statements or of specific elements, accounts or items for periods ending on or after 15 December 2016. In the case of audits of single financial statements or of specific elements, accounts or items of a financial statement as at a specific date, this HKSA is effective for audits of such information as at a date on or after 15 December 2016.

Objective

5. The objective of the auditor, when applying HKSAs in an audit of a single financial statement or of a specific element, account or item of a financial statement, is to address appropriately the special considerations that are relevant to:

   (a) The acceptance of the engagement;

   (b) The planning and performance of that engagement; and

   (c) Forming an opinion and reporting on the single financial statement or on the specific element, account or item of a financial statement.

Definitions

6. For purposes of this HKSA, reference to:

   (a) "Element of a financial statement" or "element" means an "element, account or item of a financial statement;"

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1 HKSA 800 (Revised), *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

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

(b) "Hong Kong Financial Reporting Standards" means the Hong Kong Financial Reporting Standards (HKFRSs) issued by the Hong Kong Institute of Certified Public Accountants; and

(c) A single financial statement or to a specific element of a financial statement includes the related disclosures. The related disclosures ordinarily comprise explanatory or other descriptive information relevant to the financial statement or to the element.(Ref: Para. A2)

Requirements

Considerations When Accepting the Engagement

Application of HKSAs

7. HKSA 200 requires the auditor to comply with all HKSAs relevant to the audit.[3] In the case of an audit of a single financial statement or of a specific element of a financial statement, this requirement applies irrespective of whether the auditor is also engaged to audit the entity's complete set of financial statements. If the auditor is not also engaged to audit the entity's complete set of financial statements, the auditor shall determine whether the audit of a single financial statement or of a specific element of those financial statements in accordance with HKSAs is practicable. (Ref: Para. A5-A6)

Acceptability of the Financial Reporting Framework

8. HKSA 210 requires the auditor to determine the acceptability of the financial reporting framework applied in the preparation of the financial statements.[4] In the case of an audit of a single financial statement or of a specific element of a financial statement, this shall include whether application of the financial reporting framework will result in a presentation that provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element. (Ref: Para. A7)

Form of Opinion

9. HKSA 210 requires that the agreed terms of the audit engagement include the expected form of any reports to be issued by the auditor.[5] In the case of an audit of a single financial statement or of a specific element of a financial statement, the auditor shall consider whether the expected form of opinion is appropriate in the circumstances. (Ref: Para. A8-A9)

Considerations When Planning and Performing the Audit

10. HKSA 200 states that HKSAs are written in the context of an audit of financial statements; they are to be adapted as necessary in the circumstances when applied to audits of other historical financial information.[6, 7] In planning and performing the audit of a single financial statement or of a specific element of a financial statement, the auditor shall adapt all HKSAs

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[3] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph 18

[4] HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraph 6(a)

[5] HKSA 210, paragraph 10(e)

[6] HKSA 200, paragraph 2

[7] HKSA 200, paragraph 13(f), explains that the term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework.

relevant to the audit as necessary in the circumstances of the engagement. (Ref: Para. A10-A15)

Forming an Opinion and Reporting Considerations

11. When forming an opinion and reporting on a single financial statement or on a specific element of a financial statement, the auditor shall apply the requirements in HKSA 700 (Revised), [8] and, when applicable, HKSA 800 (Revised) adapted as necessary in the circumstances of the engagement. (Ref: Para. A16-A22)

Reporting on the Entity's Complete Set of Financial Statements and on a Single Financial Statement or on a Specific Element of Those Financial Statements

12. If the auditor undertakes an engagement to report on a single financial statement or on a specific element of a financial statement in conjunction with an engagement to audit the entity's complete set of financial statements, the auditor shall express a separate opinion for each engagement.

13. The audited single financial statement or the audited specific element of a financial statement may be published together with the entity's audited complete set of financial statements. If the auditor concludes that the presentation of the single financial statement or of the specific element of a financial statement does not differentiate it sufficiently from the complete set of financial statements, the auditor shall ask management to rectify the situation. Subject to paragraphs 15 and 16, the auditor shall also differentiate the opinion on the single financial statement or on the specific element of a financial statement from the opinion on the complete set of financial statements. The auditor shall not issue the auditor's report containing the opinion on the single financial statement or on the specific element of a financial statement until satisfied with the differentiation.

Considering the Implications of Certain Matters Included in the Auditor's Report on the Entity's Complete Set of Financial Statements for the Audit of the Single Financial Statement or the Specific Element of a Financial Statement and for the Auditor's Report Thereon

14. If the auditor's report on an entity's complete set of financial statements includes:

    (a) A modified opinion in accordance with HKSA 705 (Revised);[9]

    (b) An Emphasis of Matter paragraph or an Other Matter paragraph in accordance with HKSA 706 (Revised);[10]

    (c) A Material Uncertainty Related to Going Concern section in accordance with HKSA 570 (Revised);[11]

    (d) Communication of key audit matters in accordance with HKSA 701;[12] or

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8 HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

9 HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

10 HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

11 HKSA 570 (Revised), *Going Concern,* paragraph 22

12 HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraph 13

(e) A statement that describes an uncorrected material misstatement of the other information in accordance with HKSA 720 (Revised);[13]

the auditor shall consider the implications, if any, that these matters have for the audit of the single financial statement or of the specific element of a financial statement and for the auditor's report thereon. (Ref: Para. A23-A27)

Adverse Opinion or Disclaimer of Opinion in the Auditor's Report on the Entity's Complete Set of Financial Statements

15. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole, HKSA 705 (Revised) does not permit the auditor to include in the same auditor's report an unmodified opinion on a single financial statement that forms part of those financial statements or on a specific element of those financial statements.[14] This is because such an unmodified opinion would contradict the adverse opinion or disclaimer of opinion on the entity's complete set of financial statements as a whole. (Ref: Para. A28)

16. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element of those financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if:

(a) The auditor is not prohibited by law or regulation from doing so;

(b) That opinion is expressed in an auditor's report that is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion; and

(c) The element does not constitute a major portion of the entity's complete set of financial statements.

17. The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole. This is the case even if the auditor's report on the single financial statement is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion. This is because a single financial statement is deemed to constitute a major portion of those financial statements.

Conformity and Compliance with International Standards on Auditing

18. As of August 2016 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*. Compliance with the requirements of this HKSA ensures compliance with ISA 805 (Revised).

19. Additional local guidance is provided in Appendix 2.

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[13] HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information,* paragraph 22(e)(ii)

[14] HKSA 705 (Revised), paragraph 15

Application and Other Explanatory Material

Scope of this HKSA (Ref: Para. 1, 6(c))

A1. HKSA 200 defines the term "historical financial information" as information expressed in financial terms in relation to a particular entity, derived primarily from that entity's accounting system, about economic events occurring in past time periods or about economic conditions or circumstances at points in time in the past.[15]

A2. HKSA 200 defines the term "financial statements" as a structured representation of historical financial information, including disclosures, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term "financial statements" ordinarily refers to a complete set of financial statements as determined by the requirements of the applicable financial reporting framework, but can also refer to a single financial statement. Disclosures comprise explanatory or descriptive information, set out as required, expressly permitted or otherwise allowed by the applicable financial reporting framework, on the face of a financial statement, or in the notes, or incorporated therein by cross-reference.[16] As noted in paragraph 6(c), reference to a single financial statement or specific element of a financial statement includes the related disclosures.

A3. HKSAs are written in the context of an audit of financial statements;[17] they are to be adapted as necessary in the circumstances when applied to an audit of other historical financial information, such as a single financial statement or a specific element of a financial statement. This HKSA assists in this regard. (Appendix 1 lists examples of such other historical financial information.)

A4. A reasonable assurance engagement other than an audit of historical financial information is performed in accordance with Hong Kong Standard on Assurance Engagements (HKSAE) 3000 (Revised).[18]

Considerations When Accepting the Engagement

Application of HKSAs (Ref: Para. 7)

A5. HKSA 200 requires the auditor to comply with (a) relevant ethical requirements, including those pertaining to independence, relating to financial statement audit engagements, and (b) all HKSAs relevant to the audit. It also requires the auditor to comply with each requirement of an HKSA unless, in the circumstances of the audit, the entire HKSA is not relevant or the requirement is not relevant because it is conditional and the condition does not exist. In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an HKSA by performing alternative audit procedures to achieve the aim of that requirement.[19]

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15 HKSA 200, paragraph 13(g)

16 HKSA 200, paragraph 13(f)

17 HKSA 200, paragraph 2

18 HKSAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*

19 HKSA 200, paragraphs 14, 18, and 22-23

A6. Compliance with the requirements of HKSAs relevant to the audit of a single financial statement or of a specific element of a financial statement may not be practicable when the auditor is not also engaged to audit the entity's complete set of financial statements. In such cases, the auditor often does not have the same understanding of the entity and its environment, including its internal control, as an auditor who also audits the entity's complete set of financial statements. The auditor also does not have the audit evidence about the general quality of the accounting records or other accounting information that would be acquired in an audit of the entity's complete set of financial statements. Accordingly, the auditor may need further evidence to corroborate audit evidence acquired from the accounting records. In the case of an audit of a specific element of a financial statement, certain HKSAs require audit work that may be disproportionate to the element being audited. For example, although the requirements of HKSA 570 (Revised) are likely to be relevant in the circumstances of an audit of a schedule of accounts receivable, complying with those requirements may not be practicable because of the audit effort required. If the auditor concludes that an audit of a single financial statement or of a specific element of a financial statement in accordance with HKSAs may not be practicable, the auditor may discuss with management whether another type of engagement might be more practicable.

Acceptability of the Financial Reporting Framework (Ref: Para. 8)

A7. A single financial statement or a specific element of a financial statement may be prepared in accordance with an applicable financial reporting framework that is based on a financial reporting framework established by an authorized or recognized standards setting organization for the preparation of a complete set of financial statements (for example, HKFRSs). If this is the case, determination of the acceptability of the applicable framework may involve considering whether that framework includes all the requirements of the framework on which it is based that are relevant to the presentation of a single financial statement or of a specific element of a financial statement that provides adequate disclosures.

Form of Opinion (Ref: Para. 9)

A8. The form of opinion to be expressed by the auditor depends on the applicable financial reporting framework and any applicable laws or regulations.[20] In accordance with HKSA 700 (Revised): [21]

(a) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a fair presentation framework, the auditor's opinion, unless otherwise required by law or regulation, uses one of the following phrases:

(i) the financial statements present fairly, in all material respects, in accordance with [the applicable financial reporting framework]; or

(ii) the financial statements give a true and fair view in accordance with [the applicable financial reporting framework]; and

(b) When expressing an unmodified opinion on a complete set of financial statements prepared in accordance with a compliance framework, the auditor's opinion states that the financial statements are prepared, in all material respects, in accordance with [the applicable financial reporting framework].

[20] HKSA 200, paragraph 8

[21] HKSA 700 (Revised), paragraphs 25-26

A9. In the case of a single financial statement or of a specific element of a financial statement, the applicable financial reporting framework may not explicitly address the presentation of the financial statement or of the specific element of the financial statement. This may be the case when the applicable financial reporting framework is based on a financial reporting framework established by an authorized or recognized standards setting organization for the preparation of a complete set of financial statements (for example, HKFRSs). The auditor therefore considers whether the expected form of opinion is appropriate in the light of the applicable financial reporting framework. Factors that may affect the auditor's consideration as to whether to use the phrases "presents fairly, in all material respects," or "gives a true and fair view" in the auditor's opinion include:

- Whether the applicable financial reporting framework is explicitly or implicitly restricted to the preparation of a complete set of financial statements.
- Whether the single financial statement or the specific element of a financial statement will:
  - Comply fully with each of those requirements of the framework relevant to the particular financial statement or the particular element, and the presentation of the financial statement or the specific element of a financial statement include the related disclosures.
  - If necessary to achieve fair presentation, provide disclosures beyond those specifically required by the framework or, in exceptional circumstances, depart from a requirement of the framework.

The auditor's decision as to the expected form of opinion is a matter of professional judgment. It may be affected by whether use of the phrases "presents fairly, in all material respects," or "gives a true and fair view" in the auditor's opinion on a single financial statement or on a specific element of a financial statement prepared in accordance with a fair presentation framework is generally accepted in the particular jurisdiction.

Considerations When Planning and Performing the Audit (Ref: Para. 10)

A10. The relevance of each of the HKSAs requires careful consideration. Even when only a specific element of a financial statement is the subject of the audit, HKSAs such as HKSA 240,[22] HKSA 550[23] and HKSA 570 (Revised) are, in principle, relevant. This is because the element could be misstated as a result of fraud, the effect of related party transactions, or the incorrect application of the going concern basis of accounting under the applicable financial reporting framework.

A11. HKSA 260 (Revised) requires the auditor to determine the appropriate person(s) within the entity's governance structure with whom to communicate.[24] HKSA 260 (Revised) notes that, in some cases, all of those charged with governance are involved in managing the entity, and the application of communication requirements is modified to recognize this position.[25] When a complete set of financial statements is also prepared by the entity, those person(s) responsible for the oversight of the preparation of the single financial statement or the element may not be the same as those charged with governance responsible for the oversight of the preparation of the complete set of financial statements.

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

[23] HKSA 550, *Related Parties*

[24] HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 11

[25] HKSA 260 (Revised), paragraph 10(b), 13, A1 (third bullet), A2 and A8

A12. Furthermore, HKSAs are written in the context of an audit of financial statements; they are to be adapted as necessary in the circumstances when applied to the audit of a single financial statement[26] or of a specific element of a financial statement. For example, written representations from management about the complete set of financial statements would be replaced by written representations about the presentation of the financial statement or the element in accordance with the applicable financial reporting framework.

A13. Matters included in the auditor's report on the complete set of financial statements may have implications for the audit of a single financial statement or of an element of a financial statement (see paragraph 14). When planning and performing an audit of a single financial statement or a specific element of a financial statement in conjunction with the audit of the entity's complete set of financial statements, the auditor may be able to use audit evidence obtained as part of the audit of the entity's complete set of financial statements in the audit of the financial statement or the element. HKSAs, however, require the auditor to plan and perform the audit of the financial statement or element to obtain sufficient appropriate audit evidence on which to base the opinion on the financial statement or on the element.

A14. The individual financial statements that comprise a complete set of financial statements, and many of the specific elements of those financial statements, including their related disclosures, are interrelated. Accordingly, when auditing a single financial statement or a specific element of a financial statement, the auditor may not be able to consider the financial statement or the element in isolation. Consequently, the auditor may need to perform procedures in relation to the interrelated items to meet the objective of the audit.

A15. Furthermore, the materiality determined for a single financial statement or for a specific element of a financial statement may be lower than the materiality determined for the entity's complete set of financial statements; this will affect the nature, timing and extent of the audit procedures and the evaluation of uncorrected misstatements.

Forming an Opinion and Reporting Considerations (Ref: Para. 11)

A16. HKSA 700 (Revised) requires the auditor, in forming an opinion, to evaluate whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.[27] In the case of a single financial statement or of a specific element of a financial statement, it is important that the financial statement or the element, in view of the requirements of the applicable financial reporting framework, provides adequate disclosures to enable the intended users to understand the information conveyed in the financial statement or the element, and the effect of material transactions and events on the information conveyed in the financial statement or the element.

A17. Appendix 2 contains illustrations of independent auditor's reports on a single financial statement and on a specific element of a financial statement. Other illustrations of auditor's reports may be relevant to reporting on a single financial statement or on a specific element of a financial statement (see, for example, the Appendices to HKSA 700 (Revised), HKSA 705 (Revised), HKSA 570 (Revised), HKSA 720 (Revised), and HKSA 706 (Revised)).

[26] HKSA 200, paragraph 2

[27] HKSA 700 (Revised), paragraph 13(e)

Application of HKSA 700 (Revised) When Reporting on a Single Financial Statement or on a Specific Element of a Financial Statement

A18. Paragraph 11 of this HKSA explains that the auditor is required to apply the requirements in HKSA 700 (Revised), adapted as necessary in the circumstances of the engagement, when forming an opinion and reporting on a single financial statement or on a specific element of a financial statement. In doing so, the auditor is also required to apply the reporting requirements in other HKSAs adapted as necessary in the circumstances of the engagement, and may find the considerations addressed in paragraphs A19–A21 below helpful.

Going Concern

A19. Depending on the applicable financial reporting framework used in the preparation of the single financial statement or the specific element of a financial statement, the description in the auditor's report of management's responsibilities[28] relating to going concern may need to be adapted as necessary. The description in the auditor's report of the auditor's responsibilities[29] may also need to be adapted as necessary depending on how HKSA 570 (Revised) applies in the circumstances of the engagement.

Key Audit Matters

A20. HKSA 700 (Revised) requires the auditor to communicate key audit matters in accordance with HKSA 701 for audits of complete sets of general purpose financial statements of listed entities.[30] For audits of a single financial statement or a specific element of a financial statement, HKSA 701 only applies when communication of key audit matters in the auditor's report on such financial statements or elements is required by law or regulation, or the auditor otherwise decides to communicate key audit matters. When key audit matters are communicated in the auditor's report on a single financial statement or a specific element of a financial statement, HKSA 701 applies in its entirety.[31]

Other Information

A21. HKSA 720 (Revised) deals with the auditor's responsibilities relating to other information. In the context of this HKSA, reports containing or accompanying the single financial statement or specific element of a financial statement—the purpose of which is to provide owners (or similar stakeholders) with information on matters presented in the single financial statement or the specific element of a financial statement—are considered to be annual reports for purposes of HKSA 720 (Revised). When the auditor determines that the entity plans to issue such a report, the requirements in HKSA 720 (Revised) apply to the audit of the single financial statement or the element.

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[28] See HKSA 700 (Revised), paragraphs 34(b) and A48.

[29] See HKSA 700 (Revised), paragraphs 39(b)(iv).

[30] HKSA 700 (Revised), paragraph 30

[31] HKSA 700 (Revised), paragraph 31

Name of the Engagement Partner

A22. The requirement in HKSA 700 (Revised) for the auditor to include the name of the engagement partner in the auditor's report also applies to audits of single financial statements of listed entities or specific elements of financial statements of listed entities.[32] The auditor may be required by law or regulation to include the name of the engagement partner in the auditor's report or may otherwise decide to do so when reporting on a single financial statement or on an element of a financial statement of entities other than listed entities.

Reporting on the Entity's Complete Set of Financial Statements and on a Single Financial Statement or on a Specific Element of a Financial Statement (Ref: Para. 14)

Considering the Implications of Certain Matters Included in the Auditor's Report on the Entity's Complete Set of Financial Statements for the Audit of the Single Financial Statement or the Specific Element of a Financial Statement and for the Auditor's Report Thereon

A23. Paragraph 14 requires the auditor to consider the implications, if any, of certain matters included in the auditor's report on the complete set of financial statements for the audit of the single financial statement or the specific element of a financial statement and for the auditor's report thereon. Considering whether a matter included in the auditor's report on the complete set of financial statements is relevant in the context of an engagement to report on a single financial statement or a specific element of a financial statement involves professional judgment.

A24. Factors that may be relevant in considering those implications include:

- The nature of the matter(s) being described in the auditor's report on the complete set of financial statements and the extent to which it relates to what is included in the single financial statement or a specific element of a financial statement.

- The pervasiveness of the matter(s) described in the auditor's report on the complete set of financial statements.

- The nature and extent of the differences between the applicable financial reporting frameworks.

- The extent of the difference between the period(s) covered by the complete set of the financial statements compared to the period(s) or dates of the single financial statement or the element of a financial statement.

- The time elapsed since the date of the auditor's report on the complete set of the financial statements.

A25. For example, in the case when there is a qualification of the auditor's opinion in relation to accounts receivable in the auditor's report on the complete set of financial statements, and the single financial statement includes accounts receivable, or the specific element of a financial statement relates to accounts receivable, it is likely that there would be implications for the audit. On the other hand, if the qualification of the auditor's opinion on the complete set of financial statements relates to classification of long-term debt, then it is less likely that there would be implications for an audit of the single financial statement that is the income statement, or if the specific element of the financial statement relates to accounts receivable.

[32] See HKSA 700 (Revised), paragraphs 46 and A61–A63.

A26. Key audit matters that are communicated in the auditor's report on the complete set of financial statements may have implications for an audit of a single financial statement or the specific element of the financial statement. The information included in the Key Audit Matters section about how the matter was addressed in the audit of the complete set of financial statements may be useful to the auditor's determination of how to address the matter when it is relevant to the audit of the single financial statement or the specific element of the financial statement.

Inclusion of a reference to the auditor's report on the complete set of financial statements

A27. Even when certain matters included in the auditor's report on the complete set of financial statements do not have implications for the audit of, or for the auditor's report on, the single financial statement or the specific element of a financial statement, the auditor may deem it appropriate to refer to the matter(s) in an Other Matter paragraph in an auditor's report on the single financial statement or on the specific element of a financial statement (see HKSA 706 (Revised)).[33] For example, the auditor may consider it appropriate to refer in the auditor's report on the single financial statement or a specific element of the financial statement to a Material Uncertainty Related to Going Concern section included in the auditor's report on the complete set of financial statements.

Adverse Opinion or Disclaimer of Opinion in the Auditor's Report on the Entity's Complete Set of Financial Statements (Ref: Para. 15)

A28. In the auditor's report on an entity's complete set of financial statements, the expression of a disclaimer of opinion regarding the results of operations and cash flows, where relevant, and an unmodified opinion regarding the financial position is permitted since the disclaimer of opinion is being issued in respect of the results of operations and cash flows only and not in respect of the financial statements as a whole.[34]

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[33] HKSA 706 (Revised), paragraphs 10-11.

[34] HKSA 510, *Initial Audit Engagements—Opening Balances*, paragraph A8, and HKSA 705 (Revised), paragraph A16

Appendix 1

(Ref: Para. A3)

Examples of Specific Elements, Accounts or Items of a Financial Statement

- Accounts receivable, allowance for doubtful accounts receivable, inventory, the liability for accrued benefits of a private pension plan, the recorded value of identified intangible assets, or the liability for "incurred but not reported" claims in an insurance portfolio, including related notes.
- A schedule of externally managed assets and income of a private pension plan, including related notes.
- A schedule of net tangible assets, including related notes.
- A schedule of disbursements in relation to a lease property, including explanatory notes.
- A schedule of profit participation or employee bonuses, including explanatory notes.

Appendix 2

(Ref: Para. A17)

Illustrations of Independent Auditor's Reports on a Single Financial Statement and on a Specific Element of a Financial Statement

- Illustration 1: An auditor's report on a single financial statement of an entity other than a listed entity prepared in accordance with a general purpose framework (for purposes of this illustration, a fair presentation framework).

- Illustration 2: An auditor's report on a single financial statement of an entity other than a listed entity prepared in accordance with a special purpose framework (for purposes of this illustration, a fair presentation framework).

- Illustration 3: An auditor's report on a specific element of a financial statement of a listed entity prepared in accordance with a special purpose framework (for purposes of this illustration, a compliance framework).

Illustration 1: An auditor's report on a single financial statement of an entity other than a listed entity prepared in accordance with a general purpose framework (for purposes of this illustration, a fair presentation framework).

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a balance sheet (that is, a single financial statement) of an entity other than a listed entity.
- The balance sheet has been prepared by management of the entity in accordance with the requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing a balance sheet.
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.
- The applicable financial reporting framework is a fair presentation framework designed to meet the common financial information needs of a wide range of users.
- The auditor has determined that it is appropriate to use the phrase "presents fairly, in all material respects," in the auditor's opinion.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised). The disclosure of the material uncertainty in the single financial statement is adequate.
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701 in the context of the audit of the balance sheet.
- The auditor has determined that there is no other information (i.e., the requirements of HKSA 720 (Revised) do not apply).
- Those responsible for oversight of the financial statement differ from those responsible for the preparation of the financial statement.
- The auditor has no other reporting responsibilities required under local law or regulation.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Opinion

We have audited the [balance sheet][statement of financial position][1a] of ABC Company ("the Company") as at 31 December 20X1 and notes to the financial statement, including a summary of significant accounting policies (together "the financial statement").

[1a] Delete as appropriate, different term may be used as long as it is consistent with the title of the corresponding statement.

In our opinion, the accompanying financial statement presents fairly, in all material respects, the financial position of the Company as at 31 December 20X1 in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement. [Opinion section positioned first as required in HKSA 700 (Revised)]

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statement* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. [The first and last sentences in this section used to be in the Auditor's Responsibility section. Also, the Basis for Opinion section is positioned immediately after the Opinion section as required in HKSA 700 (Revised)]

Material Uncertainty Related to Going Concern

We draw attention to Note 6 in the financial statement, which indicates that the Company incurred a net loss of ZZZ during the year ended 31 December 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. As stated in Note 6, these events or conditions, along with other matters as set forth in Note 6, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

Responsibilities of Management and Those Charged with Governance for the Financial Statement[1]

Management is responsible for the preparation and fair presentation of the financial statement in accordance with those requirements of the Financial Reporting Framework in Jurisdiction X relevant to preparing such a financial statement, and for such internal control as management determines is necessary to enable the preparation of a financial statement that is free from material misstatement, whether due to fraud or error.

In preparing the financial statement, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statement

Our objectives are to obtain reasonable assurance about whether the financial statement as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion.[1b] Reasonable assurance is a high level of assurance, but is not a guarantee that

[1] Throughout these illustrative auditor's reports, the terms management and those charged with governance may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction.

[1b] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this financial statement.

Paragraph 41(b) of HKSA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of HKSA 700 (Revised) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statement, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[2]

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statement, including the disclosures, and whether the financial statement represents the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor address]

[Date]

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[2] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statement.

Illustration 2: An auditor's report on a single financial statement of an entity other than a listed entity prepared in accordance with a special purpose framework (for purposes of this illustration, a fair presentation framework).

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of a statement of cash receipts and disbursements (that is, a single financial statement) of an entity other than a listed entity.
- An auditor's report on the complete set of financial statements was not issued.
- The financial statement has been prepared by management of the entity in accordance with the cash receipts and disbursements basis of accounting to respond to a request for cash flow information received from a creditor. Management has a choice of financial reporting frameworks.
- The applicable financial reporting framework is a fair presentation framework designed to meet the financial information needs of specific users.[3]
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The auditor has determined that it is appropriate to use the phrase "presents fairly, in all material respects," in the auditor's opinion.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Distribution or use of the auditor's report is not restricted.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided, to communicate key audit matters in accordance with HKSA 701 in the context of the audit of the statement of cash receipts and disbursements.
- The auditor has determined that there is no other information (i.e., the requirements of HKSA 720 (Revised) do not apply).
- Management is responsible for the preparation of the financial statement and oversight of the financial reporting process to prepare this financial statement.
- The auditor has no other reporting responsibilities required under local law or regulation.

[3] HKSA 800 (Revised) contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Opinion

We have audited the statement of cash receipts and disbursements of ABC Company ("the Company") for the year ended 31 December 20X1 and notes to the statement of cash receipts and disbursements, including a summary of significant accounting policies (together "the financial statement").

In our opinion, the accompanying financial statement presents fairly, in all material respects, the cash receipts and disbursements of the Company for the year ended 31 December 20X1 in accordance with the cash receipts and disbursements basis of accounting described in Note X. [Opinion section positioned first as required in HKSA 700 (Revised)]

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statement* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. [The first and last sentences in this section used to be in the Auditor's Responsibility section. Also, the Basis for Opinion section is positioned immediately after the Opinion section as required in HKSA 700 (Revised).]

Emphasis of Matter - Basis of Accounting

We draw attention to Note X to the financial statement, which describes the basis of accounting. The financial statement is prepared to provide information to XYZ Creditor. As a result, the statement may not be suitable for another purpose[3a]. Our opinion is not modified in respect of this matter.

Responsibilities of Management and Those Charged with Governance for the Financial Statement[4]

Management is responsible for the preparation and fair presentation of the financial statement in accordance with the cash receipts and disbursements basis of accounting described in Note X; this includes determining that the cash receipts and disbursements basis of accounting is an acceptable basis for the preparation of the financial statement in the circumstances, and for such internal control as management determines is necessary to enable the preparation of the financial statement that is free from material misstatement, whether due to fraud or error.

In preparing the financial statement, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

[3a] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

[4] Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

Auditor's Responsibilities for the Audit of the Financial Statement

Our objectives are to obtain reasonable assurance about whether the financial statement as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this financial statement.

Paragraph 41(b) of HKSA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of HKSA 700 (Revised) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statement, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.[5]

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statement or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statement, including the disclosures, and whether the financial statement represents the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

[5] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the financial statement.

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor address]

[Date]

Illustration 3: An auditor's report on a specific element of a financial statement of a listed entity prepared in accordance with a special purpose framework (for purposes of this illustration, a compliance framework).

For purposes of this illustrative auditor's report, the following circumstances are assumed:

- Audit of an accounts receivable schedule (that is, element, account or item of a financial statement).
- The financial information has been prepared by management of the entity in accordance with the financial reporting provisions established by a regulator to meet the requirements of that regulator. Management does not have a choice of financial reporting frameworks.
- The applicable financial reporting framework is a compliance framework designed to meet the financial information needs of specific users.[6]
- The terms of the audit engagement reflect the description of management's responsibility for the financial statements in HKSA 210.
- The auditor has concluded an unmodified (i.e., "clean") opinion is appropriate based on the audit evidence obtained.
- The relevant ethical requirements that apply to the audit are those of the Hong Kong Institute of Certified Public Accountants' *Code of Ethics for Professional Accountants*.
- Distribution of the auditor's report is restricted.
- Based on the audit evidence obtained, the auditor has concluded that a material uncertainty does not exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in accordance with HKSA 570 (Revised).
- The auditor is not required, and has otherwise not decided to communicate key audit matters in accordance with HKSA 701 in the context of the audit of the accounts receivable schedule.
- The auditor has determined that there is no other information (i.e., the requirements of HKSA 720 (Revised) do not apply).
- Those responsible for oversight of the financial statement differ from those responsible for the preparation of the financial statement.
- The auditor has no other reporting responsibilities required under local law or regulation.

INDEPENDENT AUDITOR'S REPORT

[To the Shareholders of ABC Company or Other Appropriate Addressee]

Opinion

We have audited the accounts receivable schedule of ABC Company ("the Company") as at 31 December 20X1 ("the schedule").

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[6] HKSA 800 (Revised) contains requirements and guidance on the form and content of financial statements prepared in accordance with a special purpose framework.

In our opinion, the financial information in the schedule of the Company as at 31 December 20X1 is prepared, in all material respects, in accordance with [describe the financial reporting provisions established by the regulator]. [Opinion section position first as required HKSA 700 (Revised)]

Basis for Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSAs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Schedule* section of our report. We are independent of the Company in accordance with the HKICPA's *Code of Ethics for Professional Accountants* ("the Code"), and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion. [The first and last sentences in this section used to be in the Auditor's Responsibility section, Also the Basis for Opinion section is positioned immediately after opinion section as required in HKSA 700 (Revised).]**Emphasis of Matter - Basis of Accounting and Restriction on Distribution**

We draw attention to Note X to the schedule, which describes the basis of accounting. The schedule is prepared to assist the Company to meet the requirements of Regulator DEF. As a result, the schedule may not be suitable for another purpose. Our report is intended solely for the Company and Regulator DEF and should not be distributed to parties other than the Company or Regulator DEF[6a]. Our opinion is not modified in respect of this matter.

Responsibilities of Management and Those Charged with Governance for the Schedule[7]

Management is responsible for the preparation of the schedule in accordance with [describe the financial reporting provisions established by the regulator], and for such internal control as management determines is necessary to enable the preparation of the schedule that is free from material misstatement, whether due to fraud or error.

In preparing the schedule, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters relating to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Schedule

Our objectives are to obtain reasonable assurance about whether the schedule is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this schedule.

[6a] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the report in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

[7] Or other terms that are appropriate in the context of the legal framework in the particular jurisdiction.

Paragraph 41(b) of HKSA 700 (Revised) explains that the shaded material below can be located in an Appendix to the auditor's report. Paragraph 41(c) of HKSA 700 (Revised) explains that when law, regulation or HKSAs expressly permit, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report, provided that the description on the website addresses, and is not inconsistent with, the description of the auditor's responsibilities below.

As part of an audit in accordance with HKSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the schedule, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. [8]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates, if any, and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the schedule or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is [*name*].

XYZ & Co.

Certified Public Accountants (Practising) [or Certified Public Accountants]

[Auditor address]

[Date]

[8] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the schedule.

HKSA 810 (Revised)

Issued August 2016; revised June 2017

Effective for engagements to report
on summary financial statements
for periods ending on or after 15 December 2016

Hong Kong Standard on Auditing 810 (Revised)

Engagements to Report on Summary Financial Statements

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

Unaudited Supplementary Information Presented with Summary Financial Statements A26

Auditor Association A27

Appendix 1: Illustrations of Independent Auditor's Reports on Summary Financial Statements

Appendix 2: Additional Local Guidance for Auditors to Report on Summary Financial Report

Appendix 3: Extracts of the Relevant Sections of the Companies Ordinance and the Companies (Summary Financial Reports) Regulation on the Form and Contents of Summary Financial Report

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Hong Kong Standard on Auditing (HKSA) 810 (Revised), *Engagements to Report on Summary Financial Statements,* should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to an engagement to report on summary financial statements derived from financial statements audited in accordance with HKSAs by that same auditor.

Effective Date

2. This HKSA is effective for engagements to report on summary financial statements for periods ending on or after 15 December 2016.

Objectives

3. The objectives of the auditor are:

   (a) To determine whether it is appropriate to accept the engagement to report on summary financial statements; and

   (b) If engaged to report on summary financial statements:

      (i) To form an opinion on the summary financial statements based on an evaluation of the conclusions drawn from the evidence obtained; and

      (ii) To express clearly that opinion through a written report that also describes the basis for that opinion.

Definitions

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

   (a) Applied criteria – The criteria applied by management in the preparation of the summary financial statements.

   (b) Audited financial statements – Financial statements [1] audited by the auditor in accordance with HKSAs, and from which the summary financial statements are derived.

   (c) Summary financial statements – Historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time. [2] Different jurisdictions may use different terminology to describe such historical financial information.[2a]

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

[2] HKSA 200, paragraph 13(f)

[2a] In Hong Kong, the Companies Ordinance permits a company incorporated in Hong Kong (other than those falling within the reporting exemption under Division 2 of Part 9) to send to every member of the company a summary financial report in place of the reporting documents, including a full set of the annual financial statements, under section 441 of the Companies Ordinance. The form and contents of a summary financial report are set out in sections 3 to 6 of the Companies (Summary Financial Reports) Regulation (Cap. 622E). Refer to Appendix 2 for details.

Comparatives

23. If the audited financial statements contain comparatives, but the summary financial statements do not, the auditor shall determine whether such omission is reasonable in the circumstances of the engagement. The auditor shall determine the effect of an unreasonable omission on the auditor's report on the summary financial statements. (Ref: Para. A24)

24. If the summary financial statements contain comparatives that were reported on by another auditor, the auditor's report on the summary financial statements shall also contain the matters that HKSA 710 requires the auditor to include in the auditor's report on the audited financial statements.[12] (Ref: Para. A25)

Unaudited Supplementary Information Presented with Summary Financial Statements

25. The auditor shall evaluate whether any unaudited supplementary information presented with the summary financial statements is clearly differentiated from the summary financial statements. If the auditor concludes that the entity's presentation of the unaudited supplementary information is not clearly differentiated from the summary financial statements, the auditor shall ask management to change the presentation of the unaudited supplementary information. If management refuses to do so, the auditor shall explain in the auditor's report on the summary financial statements that such information is not covered by that report. (Ref: Para. A26)

Auditor Association

26. If the auditor becomes aware that the entity plans to state that the auditor has reported on summary financial statements in a document containing the summary financial statements, but does not plan to include the related auditor's report, the auditor shall request management to include the auditor's report in the document. If management does not do so, the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately associating the auditor with the summary financial statements in that document. (Ref: Para. A27)

27. The auditor may be engaged to report on the financial statements of an entity, while not engaged to report on the summary financial statements. If, in this case, the auditor becomes aware that the entity plans to make a statement in a document that refers to the auditor and the fact that summary financial statements are derived from the financial statements audited by the auditor, the auditor shall be satisfied that:

    (a) The reference to the auditor is made in the context of the auditor's report on the audited financial statements; and

    (b) The statement does not give the impression that the auditor has reported on the summary financial statements.

    If (a) or (b) are not met, the auditor shall request management to change the statement to meet them, or not to refer to the auditor in the document. Alternatively, the entity may engage the auditor to report on the summary financial statements and include the related auditor's report in the document. If management does not change the statement, delete the reference to the auditor, or include an auditor's report on the summary financial statements in the document containing the summary financial statements, the auditor shall advise management that the auditor disagrees with the reference to the auditor, and the auditor shall determine and carry out other appropriate actions designed to prevent management from inappropriately referring to the auditor. (Ref: Para. A27)

[12] HKSA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements*

Conformity and Compliance with International Standards on Auditing

28. As of August 2016 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 810 (Revised), *Engagements to Report on Summary Financial Statements*. Compliance with the requirements of this HKSA ensures compliance with ISA 810 (Revised).

29. Additional local explanations and guidance are provided in footnotes 2a, 2b, 2c, 2d, 2e, 6a, 6b, 11a and the Appendices 1, 2 and 3.

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Application and Other Explanatory Material

Engagement Acceptance (Ref: Para. 5-6)

A1. The audit of the financial statements from which the summary financial statements are derived provides the auditor with the necessary knowledge to discharge the auditor's responsibilities in relation to the summary financial statements in accordance with this HKSA. Application of this HKSA will not provide sufficient appropriate evidence on which to base the opinion on the summary financial statements if the auditor has not also audited the financial statements from which the summary financial statements are derived.

A2. Management's agreement with the matters described in paragraph 6 may be evidenced by its written acceptance of the terms of the engagement.

Criteria (Ref: Para. 6(a))

A3. The preparation of summary financial statements requires management to determine the information that needs to be reflected in the summary financial statements so that they are consistent, in all material respects, with or represent a fair summary of the audited financial statements. Because summary financial statements by their nature contain aggregated information and limited disclosure, there is an increased risk that they may not contain the information necessary so as not to be misleading in the circumstances. This risk increases when established criteria for the preparation of summary financial statements do not exist.

A4. Factors that may affect the auditor's determination of the acceptability of the applied criteria include:

- The nature of the entity;
- The purpose of the summary financial statements;
- The information needs of the intended users of the summary financial statements; and
- Whether the applied criteria will result in summary financial statements that are not misleading in the circumstances.

A5. The criteria for the preparation of summary financial statements may be established by an authorized or recognized standards setting organization or by law or regulation. Similar to the case of financial statements, as explained in HKSA 210,[13] in many such cases, the auditor may presume that such criteria are acceptable.

A6. Where established criteria for the preparation of summary financial statements do not exist, criteria may be developed by management, for example, based on practice in a particular industry. Criteria that are acceptable in the circumstances will result in summary financial statements that:

(a) Adequately disclose their summarized nature and identify the audited financial statements;

[13] HKSA 210, *Agreeing the Terms of Audit Engagements*, paragraphs A3 and A8-A9

Unaudited Supplementary Information Presented with Summary Financial Statements (Ref: Para. 25)

A26. HKSA 700 (Revised) [16] contains requirements and guidance to be applied when unaudited supplementary information is presented with audited financial statements that, adapted as necessary in the circumstances, may be helpful in applying the requirement in paragraph 25.

Auditor Association (Ref: Para. 26-27)

A27. Other appropriate actions the auditor may take when management does not take the requested action may include informing the intended users and other known third-party users of the inappropriate reference to the auditor. The auditor's course of action depends on the auditor's legal rights and obligations. Consequently, the auditor may consider it appropriate to seek legal advice.

[16] HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraphs 53-54