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

Quality Assurance

Report 2015

Content

Foreword

Fellow members

This is the ninth annual report on the activities and output of the quality assurance department. This report explains the work carried out under the practice review and professional standards monitoring programmes, shares common findings from these programmes, and recommends ways to address the problems identified and enhance audit effectiveness.

We again achieved our annual review targets despite spending more time on developing and implementing new initiatives to enhance audit quality. We launched an e-seminar on practice review and a heath screening process to help practices identify deficiencies in their practices that have been regularly found in practice reviews and widely communicated to members. We have stressed that efforts should be made to address common deficiencies and have taken stronger actions against practices that are found to have made insufficient efforts. Results of our new initiatives have started to show in the outcome of practice reviews. The percentage of reviews closed with no follow up actions required has significantly increased from 34% to 53%. We shall continue to monitor the outcome of practice reviews and introduce new initiatives whenever needed.

In 2015, we issued two alerts, one on auditor's report signing arrangements and the other on the provisional regulations on audits of Mainland enterprises issued by the Mainland Ministry of Finance (MOF). The first alert establishes our expectations on the evidence available to support proper signing arrangements by a partner/director who is not the engagement leader, which is not uncommon in Hong Kong. The second alert gives guidance on developing a business cooperation agreement between a HK CPA and a Mainland CPA as required under the provisional regulations. Since the related working papers are now required to be kept by the Mainland CPA in the Mainland, we are working hard to develop another MoU with the MOF to allow appropriate access to those working papers and facilitate effective regulation of Hong Kong auditors.

We continued to make referrals of cross border engagements to the MOF for review under our existing MoU. Five engagements were referred in 2015. We very much appreciate the support given by the MOF.

Professional standards monitoring continued to identify issues that have been communicated previously, particularly on goodwill impairment and share based payments. We did not find any major issues on new and revised standards, primarily due to the fact that there were only few standards that have come into effect in 2015. Practices are advised to get themselves prepared for the application of some more complex but not yet effective standards, particularly those on revenue, leases and financial instruments that may affect many, if not all, of their clients.

Audit regulatory reform is moving along but its effective date still seems to be some way off. We believe that whatever changes result from the reform, the Institute will continue to play a vital role in maintaining the quality of the profession.

Last but not least, I would like to thank all members and practices for their cooperation in our review programmes. Without their effort and commitment, we would not be able to demonstrate the full value of our programmes.

Elsa Ho
Director, Quality Assurance
March 2016

Oversight of our work

The Quality Assurance Department ("QAD") has two primary areas of responsibility, practice review and professional standards monitoring.

The responsibility for oversight of QAD activities rests with the Standards and Quality Accountability Board ("the SQAB"). The SQAB ensures that QAD activities are carried out in accordance with strategies and policies determined by the Council and in the public interest. The SQAB receives and reviews yearly plans and budgets and regular progress reports from management and reports to the Council on its observations and views in relation to performance and operations. Please refer to Annex for members of the SQAB.

Our work and review outcomes – Practice review programme

Practice review is a quality assurance programme that monitors all practising certificate holders in Hong Kong engaging in provision of audit and other related assurance services. The Professional Accountants Ordinance ("PAO") has empowered the Institute to carry out practice review since 1992. The approach to practice review was revised in 2006 to bring it up to international standards and is regularly amended to maintain best practice.

The Practice Review Committee ("the PRC") is a statutory committee responsible for exercising the powers and duties given to the Institute as the regulator of auditors in Hong Kong under sections 32A to 32I of the PAO. The QAD reports to the PRC which makes decisions on the results of practice reviews. According to section 32A of the PAO, at least two thirds of the PRC members must hold practising certificates. The practising members of the PRC are drawn from the full spectrum of audit firms, representing small practices through to the Big Four. The composition of the PRC is reviewed by the Nomination Committee of the Institute every year to ensure a balanced composition. Please refer to Annex for members of the PRC.

Our work

The practice review process can be divided into three stages:

Stage 1 – Preparation

- Select practice for visit
- Agree on visit date and request key documents
- Preliminary assessment of submitted key documents including, if applicable, the completed audit health screening checklist

Stage 2 – On-site visit / inhouse desktop review

- Opening meeting *
- Conduct interviews *
- Review compliance with HKSQC1 and review selected audit files
- Summarize findings and recommendations
- Exit meeting *

* *These procedures are carried out by telephone for desktop reviews*

Stage 3 – Reporting

- Draft report to practice for formal response
- Review practice's response
- Submit Reviewer's report and practice's response to the PRC for consideration
- Advise practice of the PRC decision
- Monitor follow up action, if needed

Selection of practices for review is based on their risk profiles, developed primarily using information obtained from the electronic self-assessment questionnaire ("the EQS") and other relevant sources. The frequency of reviews of each type of practices is set out below:

Practices	Frequency of review	Note
Big Four	Annually	1
Practices with a significant number of listed clients	Subject to a full review at least every three years and an interim review during the three-year cycle	2
Other practices with listed clients	Subject to review at least every three years	3
Other practices	Based on risk profiles and random selection	4

Note:

1. This recognizes the significance of listed and other public interest entities in Big 4 client portfolios.
2. Practices with more than 20 listed clients will receive an interim review in addition to a full review every three years.
3. This is in line with international best practice.
4. Practices with other public interest clients, for example, banks, insurance companies, securities brokers, insurance brokers are given priority for reviews. A number of practices are selected for reviews on a random basis to ensure that all practices will have a chance of being selected. Practices with few audit clients and without any predetermined risk factors ("small practices") are selected for desktop reviews.

The scope of each review includes obtaining an understanding of the practice's system of quality control, assessing compliance with the practice's policies and procedures and HKSQC1 "Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements" and reviewing completed audit engagements. The extent of review work that the QAD carries out varies from practice to practice depending on the size of the practice and the nature of its client base.

In late 2014, desktop reviews were introduced for small practices in order to shorten the review cycle for all practices and better utilize our resources. Desktop reviews take place at the Institute's office and comprise a review of the latest monitoring report and one audit engagement.

Matters identified during a review are fully discussed with the practice. The QAD is responsible for drawing conclusions and making recommendations to the PRC for consideration and decisions. The PRC having regard to the report and any response by the practice to the matters raised in the report may act under the power given by the PAO, to:

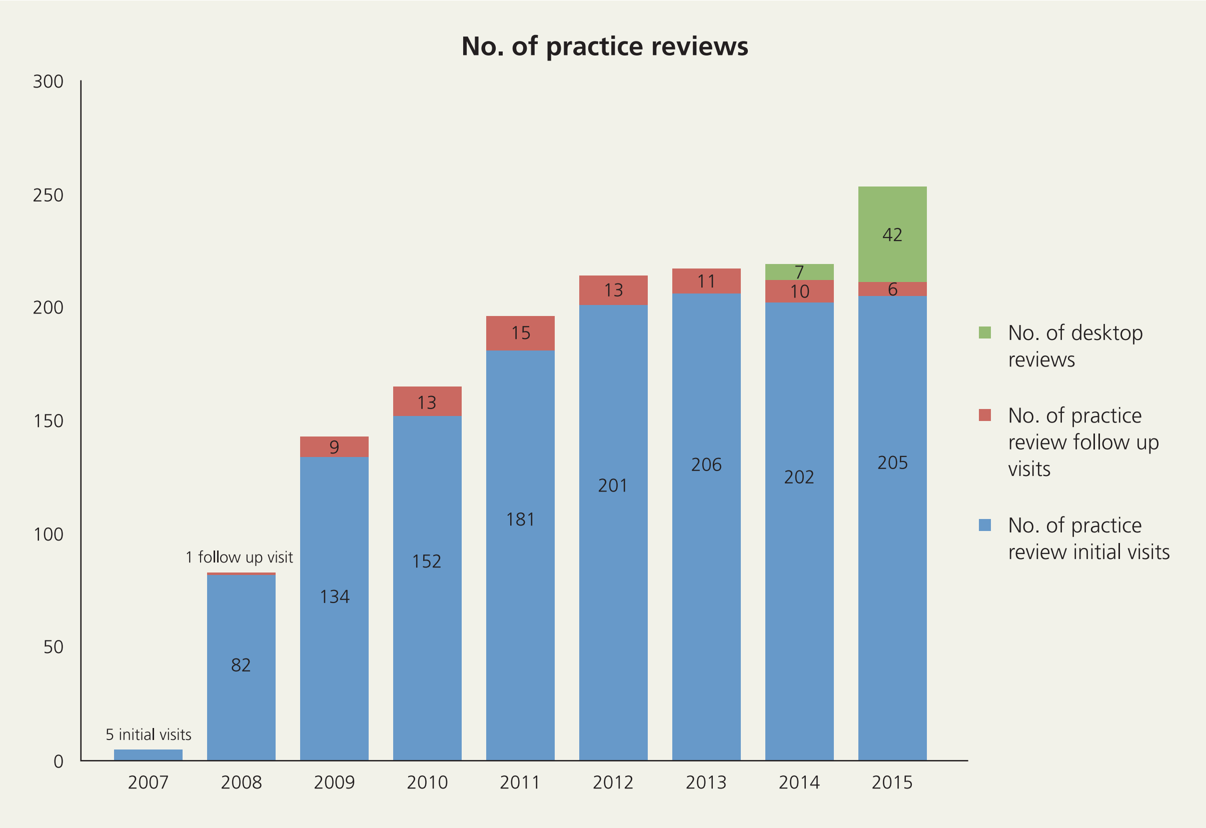
- conclude a practice review with no follow up action required ("direct closed");
- make recommendations and specific requests to a practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings ("required follow up action");
- instruct that another visit is required ("required follow up visit"); or
- make a complaint to initiate disciplinary action.

Each practice is sent a formal notification of the PRC decision. The QAD monitors the progress of actions undertaken by practices at the direction of the PRC.

If an auditing, reporting or relevant irregularity is identified in respect of a listed company, the PRC may, via the Council of the Institute, refer the case to the Financial Reporting Council ("the FRC") for investigation.

Our review outcomes

The number of reviews carried out each year has increased from 83 in 2008 to 253 in 2015. The increase in the number of reviews in 2015 was mainly due to a whole year of desktop reviews which were introduced in late 2014.

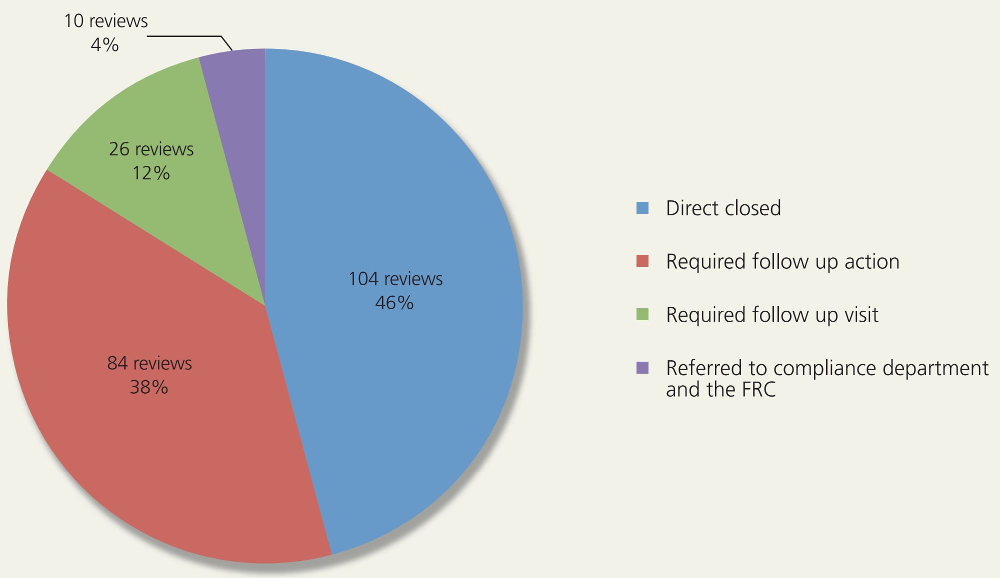


In 2015, the QAD carried out 28 visits on practices with listed clients. We referred five cross border engagements to the Ministry of Finance ("MOF") in Mainland China for review under the memorandum of understanding between the MOF and the Institute that provides for mutual assistance in discharging each respective regulatory functions. The MOF's review reports and the responses from the practices formed part of the practice review reports on the practices. The Institute very much appreciates the assistance provided by the MOF and will maintain dialogue with the MOF to enhance cooperation and coordination of review work on cross border engagements.

Since the launch of the revised practice review programme in 2007 up to December 2015, the QAD has performed 224 reviews of practices with listed clients covering 89 individual practices. For practices with listed clients where significant findings were identified, the PRC directed the QAD to conduct follow up actions or visits to ensure that findings had been properly addressed and that improvement was made on weaknesses identified. The PRC also considered referrals of those findings to the FRC and raising a direct complaint against the relevant practices.

Up to December 2015, a total of eleven audit engagements from ten reviews of practices with listed clients have been referred to the FRC for investigation. Four investigations resulted in complaints and disciplinary actions against the relevant practices as a result of serious non-compliance with professional standards and serious technical failings. The remaining seven cases are still under investigation by the FRC.

Reviews of practices with listed clients since 2007

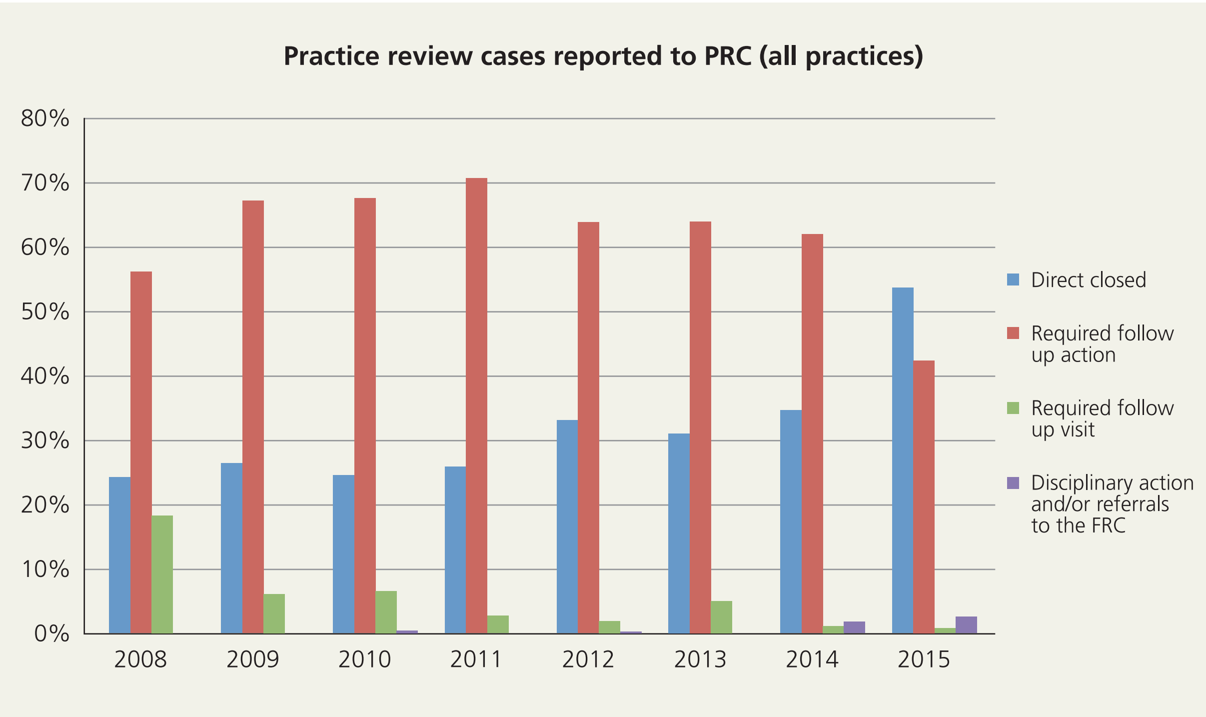


The PRC met on eleven occasions in 2015 and considered, including desktop reviews, 243 practice review reports. The PRC concluded that 130 "initial visits" should be closed without requiring any follow up actions. For 103 "initial visits", practices were required to undertake specific remedial actions and / or submit a status report on actions taken in response to practice review findings. Three reviews required a follow up visit to assess the effectiveness of remedial actions taken. Seven reviews including four practices with listed clients, proceeded to complaints and / or referrals to the FRC.

In addition to the 243 initial practice reviews, 11 follow up visits were reported to the PRC in 2015. Three follow up visits were closed on the basis that adequate remedial actions had been taken, six follow up visits required further follow up actions and, two follow up visits proceeded to complaints.

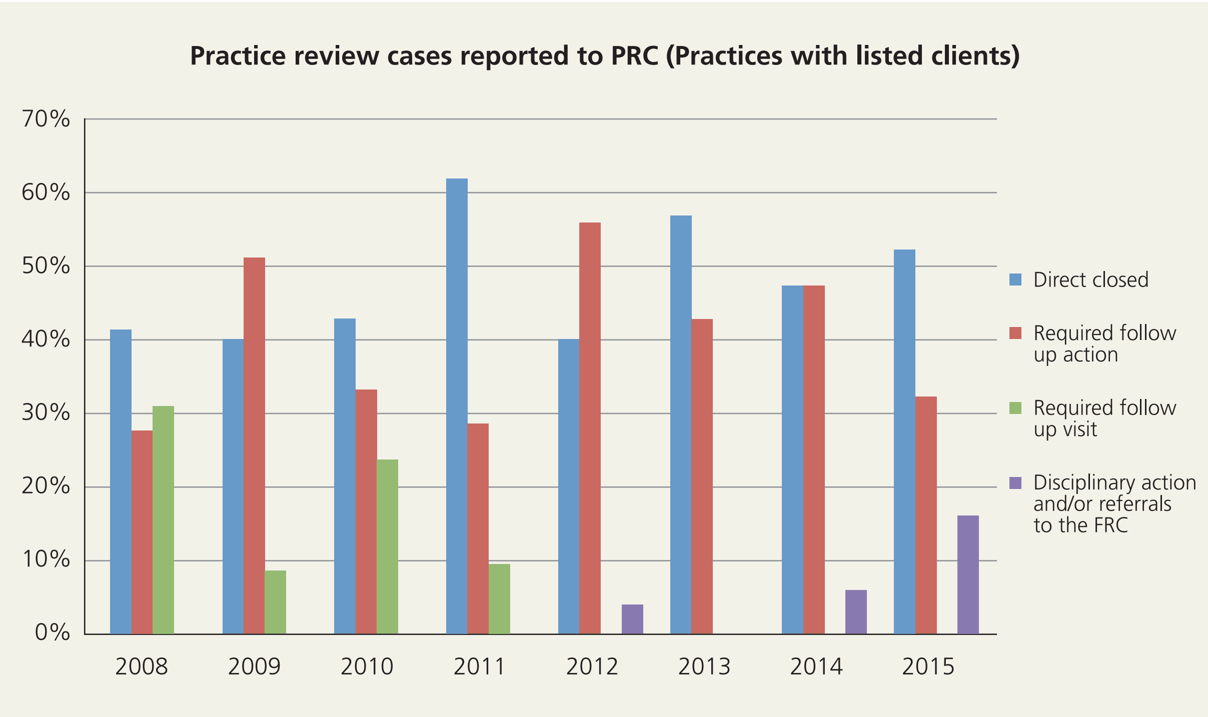
The initial practice reviews reported to the PRC which have been directly closed increased from 34% in 2014 to 53% in 2015. The improving results were mainly due to the initiatives that we implemented in the past two years to help practices improve their audit quality and better prepare for a practice review.

Initiatives introduced in 2015 included launching an e-Seminar "Improve audit quality – Practice review and common findings" and introducing the use of an Audit Health Screening Checklist on a trial basis to help identify practices with a certain extent of common deficiencies that are requested to take appropriate actions to improve themselves within a specified time. The practices are also informed that robust actions will be taken against them if the level of improvement is assessed to be unsatisfactory in the practice review. The e-Seminar is currently available for subscription at the Institute's website: http://www.hkicpa.org.hk/en/cpd-and-specialization/cpd/cpd-and-learning-resource-centre/online-courses/e-seminars/available-courses/. We shall consider extending the use of the Audit Health Screening Checklist to all practices selected for an initial practice review from 2016.

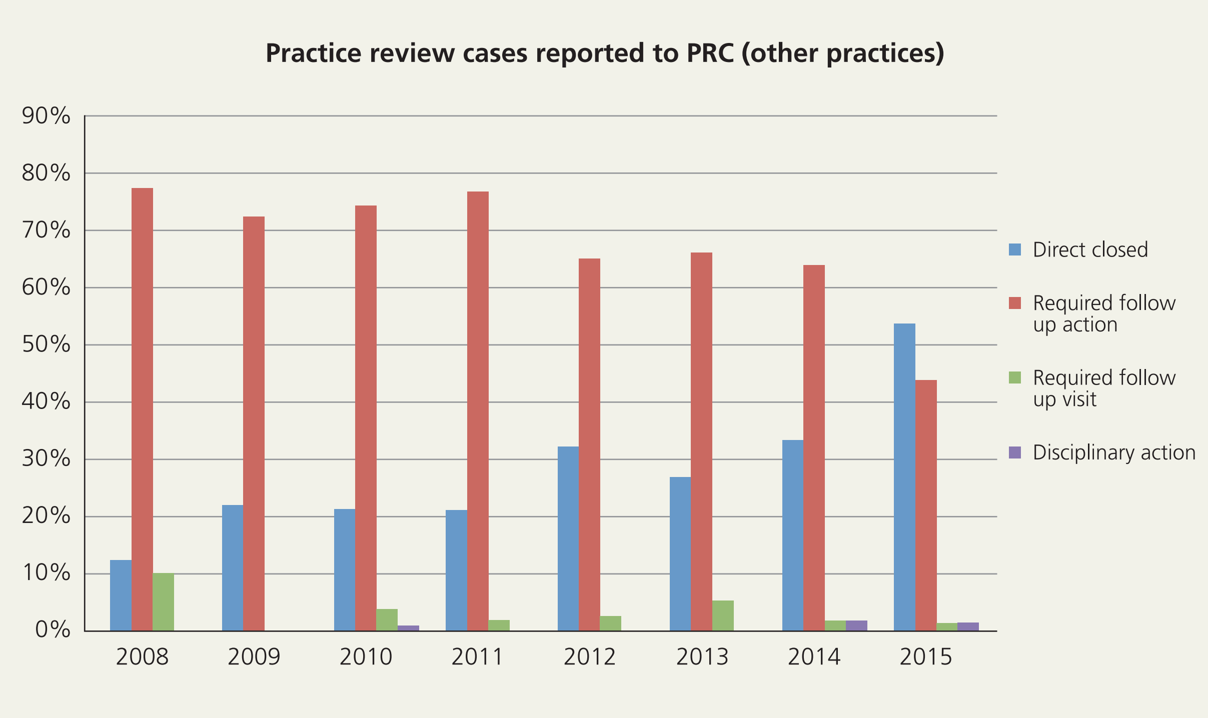


The PRC considered practice review reports on 25 practices with listed clients in 2015. Directly closed reviews have increased from 47% in 2014 to 52% in 2015 while reviews requiring follow up action have decreased from 47% in 2014 to 32% in 2015. The PRC has a policy to consider the need to refer any significant findings identified in an audit engagement of a listed client to the FRC. In the case that there is sufficient evidence of a significant audit failure, the PRC will consider raising a direct complaint as well. In 2015, one practice with listed clients proceeded to a complaint and related significant findings on a listed entity audit were referred to the FRC at the same time. Significant findings on listed entity audits of three other practices were referred to the FRC in 2015.

Out of the 25 practices with listed clients, 24 practices have previously been reviewed at least once in the three-year cycle of reviews for listed company auditors. Although these practices generally improved on prior year findings, the most recent reviews of some practices continued to identify some significant findings in audit engagements of listed clients that resulted in rigorous actions being taken by the PRC. The significant findings were mainly to do with the auditors' approach to some unusual and complex transactions undertaken by the listed clients as the practices failed to demonstrate that sufficient professional skepticism had been exercised in performing the audits. Given practices with listed clients are reviewed at least every three years, the PRC has not directed any follow up visits in the last few years but relied on monitoring of improvement at the next practice reviews.



54% of the reviews of other practices were directly closed in 2015, representing an increase of 21% from 2014. The reviews that required follow up action have decreased from 64% in 2014 to 44% in 2015. The improving results, which are mainly driven by the new initiatives introduced in the past two years, are encouraging.



In some cases, findings identified during practice review were considered to be very significant and the PRC directed the QAD to conduct follow up visits to ensure that findings had been properly addressed.

Where findings identified in a first visit amount to serious professional misconduct or in subsequent visits show that the practice has still failed to observe, maintain or apply professional standards in a significant way, the PRC may decide to make a complaint against the practising member(s) which may ultimately result in disciplinary action. Three reviews of other practices in 2015 have resulted in complaints being raised by the PRC for action under the Institute's disciplinary process.

In 2014, a letter was sent to all practices setting out the PRC's decision to take stronger action against the top 5 findings (details provided later in the report). If practices are found to have made no or little attempt to avoid those common findings, the non-compliance will be regarded as serious professional misconduct and may result in disciplinary action, even in the first visit. In 2015, one of the above three reviews proceeded to discipinary actions were first time practice review cases. In 2015, an exercise was carried out to require practices that reported no monitoring review had been carried out in the 2014 EQS to provide us with a confirmation by end of March 2015 that a monitoring review had now been carried out. Despite two reminders being sent out, a few practices did not provide us with a confirmation by the deadline. In May 2015, the PRC issued letters of disapproval to those practices and required them to be prioritized for a practice review. The PRC will continue to develop actions to ensure practices take appropriate actions to address common deficiencies on a timely basis.

Our work and review outcomes – Professional standards monitoring programme

The programme is a non-statutory financial statements review programme set up in 1988 with the objective of enhancing the quality of financial reporting and the application of professional standards in Hong Kong. It monitors compliance with professional standards by members engaged in the preparation or audit of listed company financial statements.

The QAD carries out reviews of published financial statements of Hong Kong listed companies to identify if there are any matters that indicate possible non-compliance with professional standards. The review primarily focuses on financial reporting but also looks into audit matters if significant issues are identified. Enquiry letters are issued to members (primarily auditors of the listed companies) for the matters identified. Based on the reviews of the auditors' replies to our enquiry letters, the QAD determines if follow up action is required. Follow up actions normally involve issuing follow up enquiry letters and letters with comments to advise members of areas for improvement, which are predominantly presentation and disclosures. However if the issues identified indicate significant potential non-compliance with professional standards that constitutes a "Relevant Irregularity" or "Relevant Non-compliance" as defined under the Financial Reporting Ordinance, the financial statements, and our concerns, will be referred to the Financial Reporting Council ("FRC") for investigation.

Changes are often made to the subsequent financial statements in light of our comment letters. In order to ensure that more members can benefit from our programme such that the quality of financial reporting in Hong Kong can be further enhanced, the QAD communicates common weaknesses identified from the reviews to members through different channels such as annual joint financial reporting forums and reports.

The programme is supported by the Professional Standards Monitoring Expert Panel ("Expert Panel") and independent external review firms and reviewers ("Independent Reviewers"). The Expert Panel is an advisory panel that gives advice to the QAD on the appropriate course of actions on significant, complex or controversial issues. The Expert Panel in 2015 comprised of representatives from the Big Four firms, medium-sized practising firms, Hong Kong Exchanges and Clearing Limited ("HKEx") and two non-practising members. Please refer to Annex for composition of the Expert Panel.

The Independent Reviewers assist the QAD in conducting initial reviews of financial statements. The QAD assesses the observations identified from initial reviews and determines whether an enquiry should be raised.

The Institute regularly communicates with the FRC and the HKEx which have similar financial reporting review programmes to avoid duplication of reviews.

Our work

There are three stages in the review process:

Stage 1 – Initial review

- Published financial statements assigned by the QAD to Independent Reviewers for initial reviews

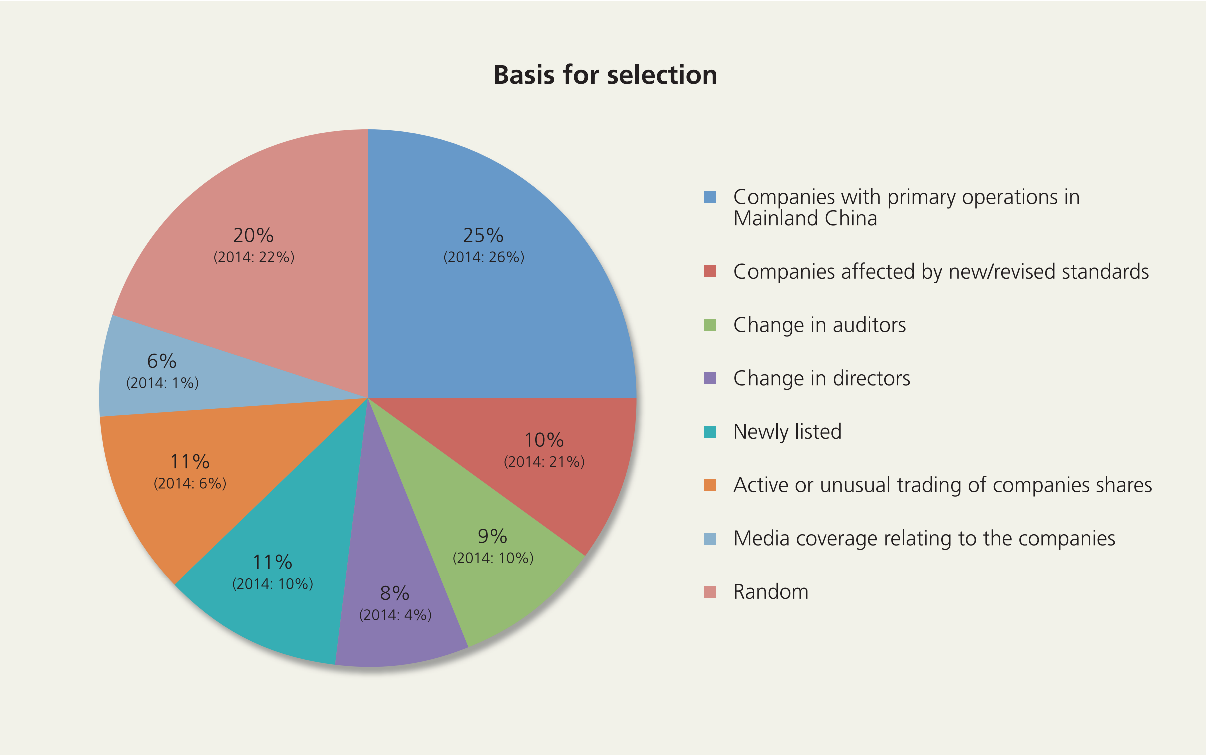
Stage 2 – QAD review

- The QAD reviews observations identified in initial reviews and issues enquiry letters to members when necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

Stage 3 – Follow up

- In cases where enquiry letters are issued, the QAD reviews reply letters from members and decides whether further enquiry or other appropriate action is necessary
- The QAD consults the Expert Panel on significant, complex or controversial issues

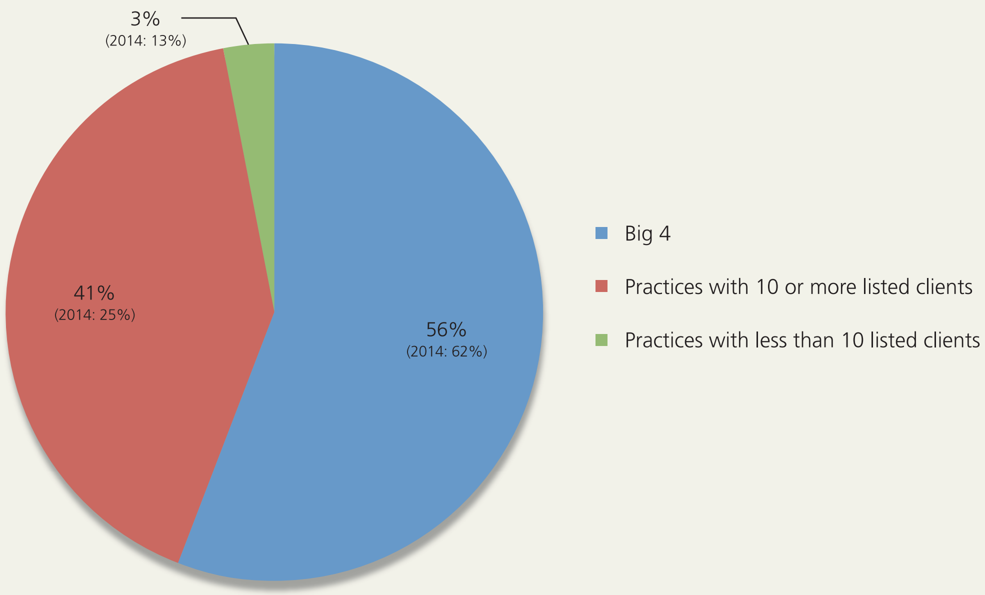
The programme adopts a risk-based approach for selection of financial statements for review. The following chart shows the basis for selection of financial statements reviewed in 2015.



As compared to 2014, a smaller portion of financial statements reviewed were for "Companies affected by new/revised standards" as only a few new and revised financial statements became effective in the financial periods beginning on or after 1 January 2014 and the impact on the majority of financial statements was minimal. As for previous years, a number of financial statements reviewed were for "Companies with primary operations in China" including some financial statements which were prepared under China Accounting Standards for Business Enterprises ("CASBE").

The following chart shows the distribution of auditors of the financial statements reviewed in 2015:

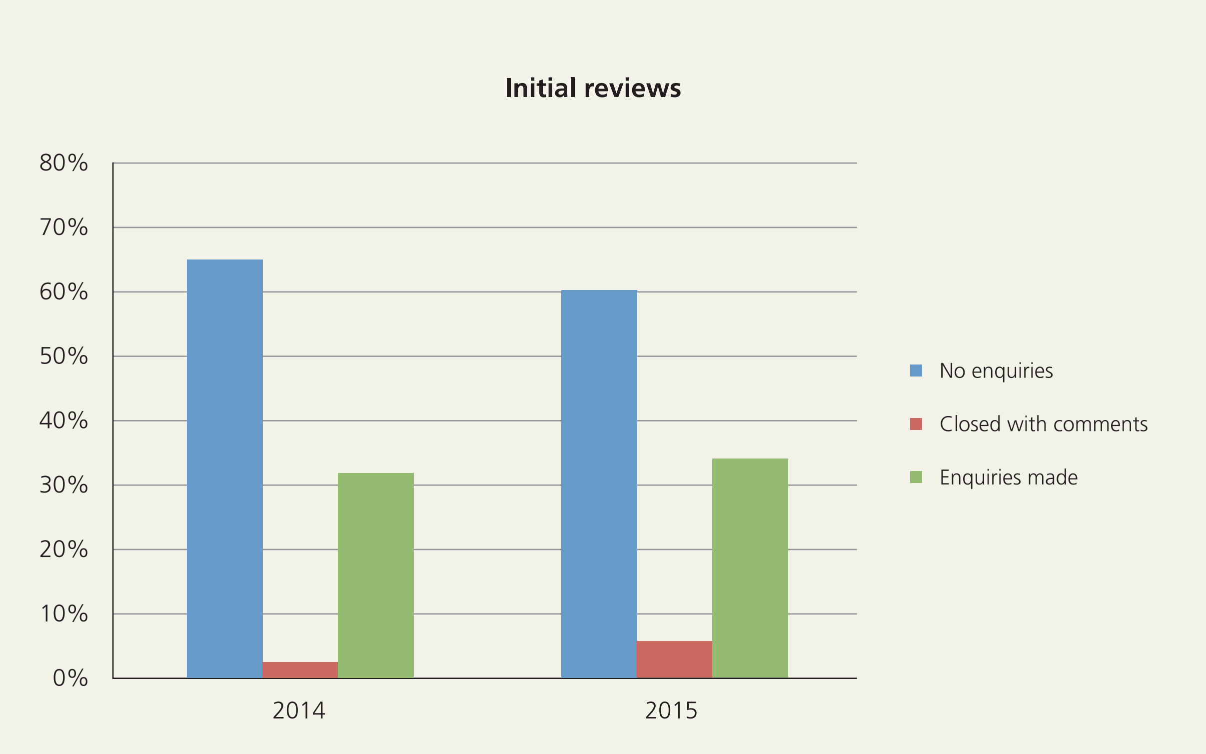
Distribution of auditors in respect of financial statement reviewed



Our review outcomes

In 2015, the QAD achieved its target with a total of 88 sets of financial statements reviewed (2014: 78 sets). The QAD also followed up 10 cases brought forward from the previous year. During the year, the QAD issued 45 letters enquiring about matters identified from reviews or making recommendations on improvements in presentation and disclosures. The QAD handled a total of 21 responses from auditors during the year. There were 76 cases closed during the year, of which 67 related to financial statements reviewed during 2015 and 9 were brought forward from the previous year.

The chart below shows that follow up action was not needed for the majority of financial statements reviewed in 2015.



Referrals are made to the FRC when the QAD identifies potential significant non-compliance with professional standards. Since 2010, a total of 10 cases have been referred to the FRC of which 2 cases were referred in 2015. In 2015, the FRC completed assessment of two referred cases including one referred in 2015, and advised that it would not pursue these two cases after obtaining further explanation and evidence from the listed companies and the auditors.

By the end of 2015, two cases that were referred to the FRC in 2014 and 2015 were still under investigation by the FRC. Of the 8 cases that the FRC has completed investigation, 4 cases have been closed with no follow up action needed and disciplinary action was taken on 1 case. 2 cases are under consideration by the Institute for regulatory action. For the remaining one, legal actions are still ongoing since the respondents had lodged an appeal against the disciplinary order issued in 2015 requiring each of them to pay a fine.

As mentioned in the 2014 annual report, one case was referred directly to the PCC for consideration of disciplinary action against the auditor as there was sufficient evidence to support a complaint based on information collected in the programme. The complaint has been resolved by "Resolution by Agreement" by which the respondents accepted a reprimand and fine.

Our findings

Practice review programme

This is the ninth annual report on our revised practice review programme. Every year we use the annual report to communicate common findings identified in practice reviews. To be clear, it is not that all these findings arise in all practice reviews, but rather that when practice review findings are considered in the aggregate these findings recur frequently, it is worth highlighting those areas for practices' particular attention. Although common findings identified in 2015 are similar to those in previous years, it is recognized that improvements have been made in terms of the extent of those findings and efforts made by practices to address those findings before the practice review cases were concluded. Common practice review findings are also consistent with the findings reported by audit regulators in other jurisdictions.

In 2015, we exceeded our visit target. We carried out 211 onsite reviews, including 6 follow up visits. To streamline our practice review procedures, we introduced in late 2014 desktop reviews for small practices that do not exhibit any pre-determined risk factors. In 2015, we performed 42 desktop reviews. Desktop reviews have proved successful in better utilizing our resources and shortening our review cycle.

Section I – Top 5 findings

We categorize review findings into significant findings and other points for attention in order to draw focus on more critical issues identified during practice reviews. Significant findings are findings that may have a more direct and material impact on the quality control system or the audit opinion, which therefore require more urgent attention and closer monitoring.

On 28 April 2014, we issued a letter to all practising members alerting them about the Top 5 findings[1]; which are the most frequently found deficiencies in practice reviews. We requested practices to take pro-active actions to remediate those deficiencies to

[1]The Top 5 findings are: (1) no or insufficient quality control policies and procedures; (2) no or ineffective monitoring function; (3) failure to carry out adequate audit procedures to satisfy requirements of auditing standards; (4) lack of controls over subcontractors' work; and (5) inappropriate use of modified opinion to circumvent necessary audit procedures. In this part of the report, we shall highlight the Top 5 findings within the common findings identified in 2015 with a "").*

uphold the quality of their work. If, in a subsequent practice review, a practice is found to have made no or insufficient effort to correct those deficiencies, such behavior will be regarded by the PRC as amounting to serious professional misconduct and consideration will be given to raising a complaint against the practice. Since 2014, more cases with the top 5 findings had been referred for disciplinary action, including some first time review cases.

Section II – Audit effectiveness

Over the years, increasing requirements of professional standards have added pressure on practices. Some practices believe that regulators are always keen to see more documents and documentation on file. In some cases, documents and documentation on file were extensive, but they did not result in an effective audit as they were irrelevant and boilerplate.

What is effectiveness? Effectiveness is commonly defined as the degree to which something is successful in producing a desired result. Under HKSAs, an effective audit should be achieved by adopting a risk-based approach that seeks to identify and assess specific risks of material misstatements relating to the financial statements of an entity and addresses them with audit procedures designed to result in audit evidence that is sufficient, relevant and reliable.

We found process deficiencies during practice reviews that hindered audit effectiveness, in particular:

(A) Poor acceptance and continuance procedures;

(B) No or insufficient planning;

(C) Failing to maintain an appropriate attitude of professional skepticism;

(D) Inappropriate audit/compliance procedures to serve test objectives;

(E) Ineffective review process;

(F) Repetitive, inconsistent and insufficient documentation; and

(G) Lack of communication with stakeholders

In addition to giving more details about the above process deficiencies, we will further discuss below in section (H) other common issues affecting audit effectiveness and in section (I) relevant resources available from the Institute on technical learning and support.

(A) Poor acceptance and continuance procedures

- HKSQC 1 sets out three basic areas which auditors should assess in carrying out client and engagement acceptance and continuance processes. They are:

  a) Auditors' competence and their capabilities including time and resources to perform the engagement;

  b) Auditor's compliance with relevant ethical requirements; and

  c) Integrity of clients.

  Practices sometimes accepted high risk clients or clients in specialized industries without giving proper consideration to resources available including sufficiency of time and manpower to adequately perform the audit. Very often, those cases ended up with costs significantly over budget and poor practice review results. In addition to auditors' independence, it is important to perform a proper evaluation of a client's integrity before accepting or continuing an appointment. Accepting a client with questionable integrity would cast doubt on the effectiveness of an audit and expose the practice to risks and costs that are hard to foresee.

(B) No or insufficient planning

- Planning

  We still found some small practices were reluctant to perform audit planning and considered planning a waste of time as they were so familiar with their audit clients. They did not understand that effective planning would save time on audit execution. Their understanding of client's backgrounds and operations would however help identify audit risk areas, which is imperative for an effective audit. HKSA 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" sets out risk assessment procedures including an understanding of clients and their environment, an evaluation of design and implementation of internal controls, and preliminary analytical procedures that engagement teams are required to perform to help identify areas that are prone to material misstatement in the client's financial statements. HKSA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" also sets out requirements for fraud assessment to help practices evaluate fraud risks of their clients and develop specific procedures to address those risks. All relevant work is required to be properly documented on file.

  Time is often critical to an audit. Once specific risk areas are identified, more time and resources should be allocated to addressing those risk areas. It is not uncommon to see that some engagement teams, in particular those from smaller practices, have spent a lot of effort and time in performing audit procedures on balances/transactions that had insignificant impact on the client's financial statements. We have also seen cases where the lack of planning had resulted in issues being identified only at a late stage, requiring the use of extra resources from other engagements to address those last minute issues.

- Materiality

  Materiality is also an area to which some small practices still fail to pay enough attention. As required by HKSA 320 "Materiality in Planning and Performing an Audit", auditors make judgements about the size of misstatements that are considered material for an audit. Those judgements provide a basis for determining the nature, timing and extent of work to be performed. Without determining materiality, it is probable that engagement teams would perform excessive work on less important areas but insufficient work on critical areas. This could compromise the effectiveness of the audit.

- Group audit plan

  Group auditors should develop an overall group audit strategy and a group audit plan and communicate their requirements to the component auditors on a timely basis. There were instances where group auditors communicated their requirements to the component auditors at a late stage and sometimes even after the component auditors had finished the audits of the components. This might mean that the work done by the component auditors was not effective for the purpose of the group audit and therefore require extra resources to perform additional work and incurring additional cost.

(C) Failing to maintain an appropriate attitude of professional skepticism

- One of the common root causes of significant engagement findings was ineffective work on risk identification and inadequate responses to identified risks. The engagement teams failed to demonstrate that they had exercised sufficient professional skepticism during the audit process. The following are some examples:

  a) A listed company recognized a right to exploit natural resources as an intangible asset. Management identified the business as a cash-generating unit ("CGU") and engaged a valuer to perform a valuation of the CGU. The valuation report showed a range of possible values of the CGU. Management adopted the high end of the range as the recoverable amount of the CGU and concluded that no impairment was required for the CGU.

     Although the engagement team considered the valuation of the intangible asset as a significant area, they failed to exercise sufficient professional skepticism in responding to the risk. We found that the exploitation and production plan had been deferred for some years but the key assumptions used in the previous year valuation report were again applied in the current year without any changes. The engagement team failed to critically challenge (i) the appropriateness of the management approach of using the high end point estimate for the valuation; and (ii) the key assumptions used in the valuation, especially those without support of past experience.

  b) In some engagements, the related entities had undertaken some significant and/or unusual transactions during the reporting period, but the engagement teams failed to identify them as significant risk items and obtain an adequate understanding of their nature. Practices should carry out procedures in addition to standard audit procedures that apply to normal transactions to specifically address the additional risks arising from significant and/or unusual transactions.

  c) In evaluating the work performed by the client's expert (Expert A), the engagement team obtained information from another expert (Expert B) but did not take into account that information in their evaluation because they considered that the information from Expert B contradicted some key assumptions used in the valuation report issued by Expert A. We considered the evaluation had not been adequately performed as it failed to question contradictory evidence. The engagement team also failed to demonstrate that they had exercise sufficient professional skepticism.

(D) Inappropriate audit/compliance procedures to serve test objectives

- We identified a number of instances where the engagement teams failed to design appropriate audit/compliance procedures to address identified risks or realize that the procedures carried out did not serve the testing objectives. Typical examples were that the engagement team:

  a) Checked invoice dates to ensure proper cut off but the dates did not show when the titles of goods passed;

  b) Carried out compliance procedures for licensed corporations and insurance brokers, without first obtaining an appropriate understanding of the client's businesses, and relevant requirements of laws and regulations;

  c) Checked only latest supplier invoices without considering whether the costing method (e.g. weighted average costing) had been properly applied.

(E) Ineffective review process

- Ineffective engagement partners/directors' reviews

  From time to time, we identified practices with many significant deficiencies. This raised concerns about the effectiveness and robustness of file reviews by engagement partner/director. In many of those cases, we found little evidence of engagement partner/director's reviews on file or that they had timely involvement in the audits. Practices are reminded that the engagement partner/director bears ultimate responsibility for the quality of the audit. Their timely involvement is crucial to adequately control the quality of work done by their staff. They should also appreciate that their timely involvement and input should help identify issues earlier, save time and enhance effectiveness.

  Paragraph A11 of HKSA 230 "Audit Documentation" provides that auditors 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 audit documentation, particularly for large and complex audits.

  Furthermore, the preparation of a completion memorandum may assist the engagement partner/director to focus their attention on significant matters and help them consider whether, in light of the audit procedures performed, the conclusions reached are appropriate and have met all relevant requirements.

- Ineffective engagement quality control ("EQC") reviews

  There is also a requirement under HKSQC 1 to have an EQC review carried out for an audit of a listed entity before the audit report is issued. An effective EQC review should enhance audit quality. However, we sometimes found evidence in some audits that the EQC reviews carried out were not effective as they failed to identify critical issues or effectively challenge the engagement team's judgements on critical areas.

  There have been disciplinary cases where the EQC reviewers were penalized for their lack of due care. Practices should take steps to evaluate effectiveness of the EQC reviews, including assessment of competence and capabilities of EQC reviewers and quality of their reviews. Appropriate follow up actions should be undertaken if weaknesses are identified.

- No or ineffective monitoring function ***(Top 5)**

  One of the Top 5 findings is no or ineffective monitoring review. Since actions have been taken in 2014 to reinforce the importance of the monitoring review, practices now generally have their monitoring reports ready for our review at the time of practice review. In previous annual reports, we have explained the common deficiencies identified in practices' monitoring functions, including (a) no evidence of the reviews performed; (b) reviews were performed only on simple or inactive engagements; (c) no follow up actions were taken to address the findings; and (d) the monitors had inappropriate authority or technical expertise. These deficiencies still found in our reviews carried out in 2015.

  An effective monitoring review should provide practices with reasonable assurance that their quality control policies and procedures are relevant, adequate, and operating effectively. When monitors identify weaknesses, practices should take them seriously and discuss remedial actions with the monitors. Sometimes, we noted that follow up actions did not effectively address the root causes. Practices should identify the root causes of weaknesses and develop appropriate follow up actions accordingly.

(F) Repetitive, inconsistent and insufficient documentation

- Repetitive and inconsistent documentation

  Repetitive and inconsistent documentation is another common finding. Engagement teams might sometimes be required to record the same information in different places of the files. For instance, results of risk assessment might have to be documented in different forms under the planning section. Sometimes risks identified were shown in one form but not in others or the risk levels determined for the same assertions, as documented, were different in different forms. Practices should review and revise their templates or standard documents to reduce the chance of having inconsistent information in different parts of the file. This would save time wasted on producing repetitive documentation and make files easier to review and update if necessary at a later stage.

- Misuse of sample documentation

  Some engagement teams copy or only update work from the last year file for the current year audit. This practice might be appropriate for work on some areas of the audit but not all, in particular for those critical areas needing a new assessment every year. In respect of areas that mainly require updating on a year on year basis e.g. business modes, management and internal controls, practices might consider how documentation can be made more effective and efficient, e.g. prepare full documentation in year one and then update the documentation only for changes in subsequent years. Consideration can also be given to putting the original documents on a permanent file.

- Ineffective documentation of understanding of internal controls

  Obtaining an understanding of internal controls from discussions with the client is generally more effective than completing an internal control checklist alone, in particular when the client operates in a specialized industry. A checklist can only provide an aide-memoire to assist the engagement team in understanding the client's systems and identifying controls, and standard questions in the checklist might not necessarily relevant to a particular client. Once system notes are prepared, links should be established between identified risks of material misstatements and relevant control procedures so as to help evaluate the design and implementation of those control procedures during the audit. The notes should also be updated for changes on a year on year basis.

- No or insufficient documentation

  Regulators are generally more concerned about the quality of what is recorded in the documentation rather than the volume of documentation. Paragraph 8 of HKSA 230 states clearly that auditors shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

  a) The nature, timing, and extent of the audit procedures performed to comply with the HKSAs and applicable legal and regulatory requirements; (Ref: Paragraph A6 to A7 of HKSA 230)

  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: Paragraph A8 to A11 of HKSA 230)

Practices should bear the above in mind when carrying out an audit. The lack of documentation would provide a strong indication, if not evidence, of lack of work done. Below are examples of common documentation deficiencies and our usual comments on those deficiencies:

Deficiencies	Our comments
In respect of work to verify the client's assertion that adopting the new or revised accounting standards effective for the current year had no material impact on the financial statements, the engagement team advised that they had recorded in their audit programmes that they reviewed the client's accounting policies and ensured that they were in accordance with applicable accounting standards.	Completing the audit programmes did not serve to provide evidence that the engagement team had appropriately assessed the impact of adopting the new or revised accounting standards. The documentation should show the specific procedures performed in this respect.
For impairment assessment, other than having the relevant valuation report on file, audit documentation simply recorded that "The engagement team had evaluated the key assumptions used in the valuation and concluded that they can rely on the report in their impairment assessment".	Without providing further details of how the engagement team had performed the evaluation of key assumptions, it is difficult to conclude that appropriate work had been carried out. In addition, there was no evidence to show that the engagement team had (i) evaluated competence, capabilities and objectivity of the management's expert; and (ii) reviewed the relevance and accuracy of source data used in the valuation, as required to be carried out under HKSA 500 "Audit Evidence" to appropriately assess the work of the valuer before accepting the valuation as audit evidence.
In a sales transaction test, the engagement team only recorded that "supporting documents were checked".	The audit documentation did not give information about what supporting documents were checked and whether the extent of checking was appropriate and sufficient.

Audit documentation showed that revenue recognition of a trading company was not considered as a risk item.	There was no documentation to show how the engagement team had rebutted the presumption that there are risks of fraud in revenue recognition as required by paragraph 47 of HKSA 240.
The engagement team recorded "done" in the programmes to indicate that the journal entries review had been performed.	The documentation did not provide details of work done, including sampling basis, items tested and evidence checked.
In respect of fraud assessment, the engagement team marked "N/A" to most of the questions in the fraud checklist, including a question prompting the engagement team to make inquiry with management about fraud.	The engagement team should record more details of the work done to support the conclusion. If a fraud enquiry had been made with management, information including the person(s) to which the enquiry was made, the date and timing of the enquiry and the key matters discussed should be set out in audit documentation to evidence the work performed.
In respect of independence assessment, the engagement team recorded details of non assurance services provided to the client, but there was no assessment of threats to independence and safeguards required.	In addition to documenting relevant facts and circumstances, it is important for the engagement team to perform "threats and safeguards" evaluation and properly record their assessment.

(G) Lack of communication with stakeholders

We sometimes identified that practices met with their clients' management and audit committee at a very late stage of their audits. Although it is important for auditor to maintain independence and objectivity, timely communication between auditor, management and those charged with governance is important to avoid misunderstanding and last minute surprises. This also helps enhance efficiency and effectiveness of the audit. Templates of communication can be useful to assist engagement teams to document their communication with management and audit committee and to achieve compliance with the relevant auditing standard.

(H) Other common issues affecting audit effectiveness

During practice reviews, we identified the following issues that cast doubt on whether an effective audit had been performed.

- Failure to carry out adequate audit procedures to satisfy requirements of auditing standards ***(Top 5)**

  There are still practices that do not understand or have not made sufficient efforts to meet some basic requirements of standards, particularly in the areas of audit planning and completion. Although the number of practices failing to perform any work at all on planning and/or completion has reduced over the recent years, we are still concerned about deficiencies still being identified as those requirements have been in place for a decade since December 2005.

  The Institute developed and published the Audit Practice Manual ("APM") to provide a tool to assist application of auditing standards and to facilitate better audit documentation. Some practices still wrongly believe that acquiring the APM is imperative to meet our expectations even though they failed to make use of the APM guidelines and programmes when carrying out their audits. Some practices simply use the basic "Flat Holdings Limited" example from the APM to reproduce documentation for every audit resulting in documentation often not being specific to their clients.

- No or insufficient quality control policies and procedures ***(Top 5)**

  In previous years, we often found that small practices did not have quality control policies and procedures. In recent years, more small practices have adopted example quality control manuals included in the Institute's publication, A Guide to Quality Control but some still have not tailored the manuals for their own needs.

  We recommend practices take steps to tailor the example manual before adopting it as their quality control manual. In particular, they should read carefully the content of the example manual and consider whether the policies and procedures suit their circumstances. They should then make appropriate changes to the example manual before adopting the manual for use. However, care should be taken to ensure the changes would not result in policies and procedures not fulfilling the requirements of HKSQC 1.

  The manual can be a good communication tool between partners/directors and staff to set standards and expectations and can be used to set a foundation for developing performance evaluation criteria.

- Lack of understanding of audit programmes and checklists

  Some practices have developed sophisticated audit programmes and checklists to help engagement teams carry out audit procedures sufficient to meet all requirements of standards. However, they did not take steps to ensure engagement teams understand the programmes and checklists and how they should be applied. Therefore, engagement teams could have spent countless hours in working through the programmes and checklists but still had not attained the objectives that the programmes and checklists intended to achieve.

- Over-reliance on experts' work

  In previous reports and forums, we have repeatedly emphasized the need to properly assess the work of experts if practices intend to rely on their work. As in 2014, there were a number of instances identified in 2015 where insufficient efforts had been made to meet the relevant requirements of HKSA 500 and HKSA 620 "Using the Work of an Auditor's Expert". Some auditors take the view that, since they are not experts on the subject matter, valuation reports from external experts are reliable so long that they have checked the experts' qualification and independence.

  Practices are reminded that they have sole responsibility for the audit opinion expressed and that responsibility is not reduced by using the work of management's experts or the practices' own experts. Auditing standards require that before relying on expert's work, auditors should perform the following work:

  a) Evaluate competence, capabilities and objectivity of the expert;

  b) Obtain an understanding of the expert's work; and

  c) Evaluate the appropriateness of the expert's work, including:

     i) Review of the appropriateness of key assumptions and valuation methods;

     ii) Review or test the data used by the expert; and

     iii) Assess the relevance and reasonableness of the expert's findings or conclusions, and their consistency with other audit evidence.

  Practices should also properly document all work performed.

- Inappropriate substantive analytical procedures

  Substantive analytical procedures can allow auditors to reduce other substantive work so as to make the audit process more cost effective. However, we often found analytical procedures performed were limited to a simple comparison of current year and previous year data. This alone does not constitute substantive analytical procedures.

In order to reduce other substantive work, practices should perform proper substantive analytical procedure as required by HKSA 520 "Analytical Procedures", which include developing expectations and thresholds, testing data used for developing expectations, and obtaining corroborative evidence for variances identified.

- Lack of control over subcontractors' work ***(Top 5)**

  In previous reports and forums, we have commented that subcontracting arrangements are acceptable mechanisms to engage staff resources, as long as practices exercise appropriate control over the subcontractors' work. However, we often found the quality of work of subcontractors to be unsatisfactory and that engagement partners/directors had little involvement in the audit engagements. Common issues identified in subcontracting arrangements include:

  a) Practices accepted new audit clients referred by their subcontractors without considering whether they have sufficient resources to properly supervise the new audit engagements and whether the subcontractors are competent to perform audits;

  b) Practices did not have an adequate knowledge of their subcontractors' other business activities, particularly whether the subcontractors also provided non-assurance services to the audit clients. The potential independence threats created by such an arrangement should be fully considered before accepting the clients or continuing the audit appointments;

  c) Subcontractors performed almost all audit procedures and managed the client relationship without adequate involvement of the practices. Therefore, the practices had little understanding of their audit clients and did not control or get involved in any critical parts of the audits, such as risk assessment and development of risk responses and/or review of the subcontractors' work before signing the audit opinion; and

  d) Subcontractors did not follow the practices' quality control system and/or audit methodology. This created serious doubts over how the practices controlled or were satisfied with the quality of subcontractors' work.

  Practices with subcontracting arrangements must understand that they bear ultimate responsibility for all audits, including subcontracted engagements. The use of a subcontractor is not a defense in case of an audit failure. Subcontractors only act in the capacity of staff, albeit engaged by a different mechanism. In many situations, the use of incompetent subcontractors and lack of proper involvement of the practices in the engagements are the main factors leading to poor audit quality. If a practice cannot properly control or supervise the work of a subcontractor, the subcontracting arrangement should not continue.

- Over-reliance on internally generated documents

  In carrying out audit tests, many small practices rely on documents generated by the client without giving due consideration to their reliability. Typical examples were (a) checking sales invoices/ service billings to verify occurrence and cut off in transaction and cut-off tests; and (b) relying on ageing reports to assess recoverability of receivables and appropriateness of inventory provision.

  HKSA 500 requires auditors to consider the reliability of information used as audit evidence. The reliability of information used as audit evidence is influenced by its source and nature and the circumstances under which it is obtained. The following are the guidelines set out in HKSA 500:

  a) Reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

  b) 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.

  c) Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.

  d) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally.

  e) 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.

  Practices are advised to bear the above guidelines in mind when determining whether reliable evidence has been obtained to support their conclusions.

- Inappropriate use of a modified audit opinion to circumvent necessary audit procedures ***(Top 5)**

  Some practices use a modified opinion to circumvent audit procedures. They considered this approach saved costs while still enabling them to properly discharge their responsibility as auditor. Some did this due to pressure from clients to minimize audit costs. Examples are as follows:

  a) Reporting deadlines

     Client information was only made available to the practice near the reporting deadline. In order to meet the tight deadline, and save cost, the practice issued a modified report that disclaimed all parts of the financial statements on which it was unable to obtain sufficient evidence before the deadline. Lack of time is not a valid reason for issuing a modified audit opinion. The auditor should assess the potential impact of time constraints and resource requirements before making a decision on accepting or continuing with the audit appointment.

b) Inventory counts

The practice issued modified reports year after year because the client did not invite them to attend the year end inventory count. While it might be difficult to establish whether there is a real limitation or it is only a way to avoid carrying out a required audit procedure in the first year audit, suspicions are heightened when a similar limitation has persisted for a number of years and the practice failed to demonstrate that they had made any effort to resolve the limitation.

Where a scope limitation is truly imposed by a client, practices should consider alternative audit procedures and should issue a modified opinion only when there are no alternative procedures or where such alternative procedures fail. Paragraph A9 of HKSA 705 "Modifications to the Opinion in the Independent Auditor's Report" states that limitations imposed by management may have other implications that need to be addressed by the auditor such as in engagement continuance. Section 410.52 of the Code of Ethics also states that significant limitations imposed by client may infringe on the practice's statutory duties as auditor. Practices should normally not accept appointment or reappointment as auditor in those circumstances.

(I) Resources

We understand practices may find difficult to keep technical knowledge up to date in the ever-changing environment of the modern audit profession due to limited internal resources. The Institute's website contains useful technical resources and materials, including the following, which would help practices in this regard:

- The Institute's Quality Assurance Department has issued a number of publications including quality assurance reports and alerts, that set out common findings identified from practice reviews and recommended practices to address those deficiencies. Practices can access these materials through the following link: http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/practice-review/publications-reference/.

- Practices can gain knowledge about the background and review highlights of the new/revised accounting standards by visiting the staff summary of new accounting standards at the Institute's website: http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/staff-summary/ and, based on the information provided, perform a preliminary assessment of how the standards would affect their clients at an early stage.

- Other technical resources, including articles on new auditing standards, SME-FRS and Companies Ordinance, are available on the Institute's website http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/.

- Practices are encouraged to develop an adequate training plan for their staff, including updates on professional standards. In addition to seminars and workshops, the Institute provides some e-learning facilitate at its CPD learning centre http://www.hkicpa.org.hk/en/cpd-and-specialization/cpd/cpd-and-learning-resource-centre/.

Section III – Our expectations

Auditors are facing many challenges in recent years, e.g. the new Companies Ordinance and changes in financial reporting and auditing standards, and there will be more changes to come, e.g. new requirements for auditor's report. It is time for practices to reconsider the effectiveness of their current audit approach. Practices might recognize that ineffective policies and procedures described in this report also exist in their own quality control systems and/or audit methodology. Practices are recommended to consider the suggestions provided in this report and take appropriate actions to enhance their audit effectiveness. After all, effective policies and procedures are keys to a good quality audit.

Our findings

Professional standards monitoring programme

This section sets out the more significant or common findings identified from our review of Hong Kong listed companies' financial statements during 2015. We hope that members (both auditors and preparers of financial statements) would find this report useful to enhance their understanding of Hong Kong Financial Reporting Standards ("HKFRSs"). HKFRSs referred to in this report include all Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ("HKASs") and Interpretations issued by the Institute.

In the 2015 reviews, other than the matters regarding the Amendments to HKAS 32 *Financial Instruments: Presentation* that shall be further discussed below, no major issues were identified in respect of initial application of the new and revised HKFRSs. The issues identified mainly relate to the application of the existing HKFRSs, including some recurring deficiencies that have been covered in previous reports.

We shall first cover below the issues identified from initial application of the Amendments to HKAS 32 on offsetting requirements for financial assets and financial liabilities. In the second section, we shall discuss the issues relating to other HKFRSs including HKFRS 2 *Share-based Payment*, HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, HKAS 12 *Income Taxes*, HKAS 28 (2011) *Investments in Associates and Joint Ventures*, and HKAS 36 *Impairment of Assets*. An overview of common disclosure deficiencies is set out in the third section.

Section I – Initial application of new and revised HKFRSs

Amongst the few new and revised HKFRSs that are effective from 2014, the Amendments to HKAS 32 are more relevant to the financial statements reviewed.

1. Amendments to HKAS 32 – *Offsetting Financial Assets and Financial Liabilities*

   The Amendments to HKAS 32 were issued in conjunction with the Amendments to HKFRS 7 *Financial Instruments: Disclosures* in December 2011. The Amendments to HKAS 32 were effective for annual periods beginning on or after 1 January 2014. The new offsetting disclosure requirements under HKFRS 7 had been effective earlier – for annual periods beginning on or after 1 January 2013. Both Amendments are to be applied retrospectively to all comparative periods.

The Amendments to HKAS 32 have not changed the offsetting model provided in HKAS 32 paragraph 42, which requires that a financial asset and a financial liability shall be offset (i.e. not an accounting policy choice) and the net amount presented in the statement of financial position, when and only when, the following two conditions are satisfied:

(a) currently has a legally enforceable right to set off the recognized amounts; and

(b) intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously.

The Amendments clarify the requirements of the above two conditions to address the inconsistencies in market practice when applying the offsetting model. A master netting arrangement is commonly used by financial institutions to provide protection against loss in the event of circumstances (e.g. bankruptcy) that result in a counterparty being unable to meet its obligations (HKAS 32 paragraph 50). Such kind of master netting arrangements do not meet condition (a) of HKAS 32 paragraph 42 and the Amendments (HKAS 32 paragraph AG38B) clarify this by emphasizing that the right of set-off must not be contingent on a future event. A master netting arrangement only provides a basis for offsetting if both of the criteria under HKAS 32 paragraph 42 are satisfied.

Disclosures in some financial statements showed that some financial assets and financial liabilities had been set off against each other. However, due to insufficiency of disclosures, it was unclear whether the requirements of HKAS 32 had been complied with. For example, a financial institution reviewed presented a single line item “clearing settlement funds” in its consolidated statement of financial position. It appears that the financial institution had captured all balances relating to its clients and its own proprietary trading with clearing houses (i.e. amounts “due from” and “due to” clearing houses) in this line item, as no other balances relating to the trading with the clearing houses were noted in the financial statements. In view of its nature of operations, the financial institution’s activities (e.g. margin financing, security lending transactions, etc.) may be subject to offsetting or master netting arrangements. If that is the case, the disclosures required by HKFRS 7 paragraphs 13A to F should have been made to support the conclusion that the offsetting criteria under HKAS 32 paragraph 42 were met.

In the review of the financial statements of another reporting entity, it was noted that the carrying amount of “deposits paid to fellow subsidiaries” recognized in the “company level” statement of financial position was greater than the amount reported in the “consolidated” statement of financial position. As those fellow subsidiaries are outside the group of the reporting entity, the reporting entity’s balances with those fellow subsidiaries should not have been eliminated in the consolidation. This brought into question whether, in the consolidated statement of financial position, the group’s liabilities with those fellow subsidiaries had been offset against the deposits paid by the company; and, if so, whether the offsetting requirements of HKAS 32 had been complied with.

Members are reminded that additional disclosures set out in paragraphs 13A to 13F of the amended HKFRS 7 are required to enable users of financial statements to evaluate the effect or potential effect of netting arrangements on an entity's financial position. The relevant quantitative information as required by HKFRS 7 paragraph 13C shall be disclosed in a tabular format, unless another format is more appropriate.

Section II – Common or significant findings of other HKFRSs

1. HKFRS 2 *Share-based Payment*

   Entities, often listed entities, issue share options to employees and other parties to give them rights to buy their shares at a specified price within a specified time period. There are also entities which issue shares or share options to suppliers. Under these situations, HKFRS 2 applies. Members should however note that HKFRS 2 applies to all entities, not only listed entities.

   HKFRS 2 has been effective since 2005. However we still identified issues from our reviews occasionally which indicate that some members are not conversant with the requirements of HKFRS 2. A common example is that an entity determined not to recognize share-based payment expenses solely because not all the vesting conditions for the share options granted have been satisfied. This is not acceptable under HKFRS 2 (more explanation is given below). Therefore, we consider there is a need to remind members of some key requirements of HKFRS 2. We have covered accounting issues on share-based payment transactions with employees and consultants in our last year's report. We shall address other aspects of equity-settled share-based payment transactions below.

   a. Scope of HKFRS 2

      Other than the situations specified in HKFRS 2 paragraphs 5 and 6 (e.g. assets acquired as part of net assets in a business combination), all goods or services, such as employee services, acquired in a share-based payment transaction are recognized as expenses or assets as appropriate (HKFRS 2 paragraph 8). HKFRS 2 also specifies the accounting requirements for group share-based payment transactions such as transactions that are settled by another group entity (or a shareholder of any group entity) on behalf of the entity receiving or acquiring the goods or services (HKFRS 2 paragraph 3A).

   b. Recognition and measurement of "equity-settled" share-based payment transactions – transactions measured by reference to the fair value of the equity instruments granted

      Regarding equity-settled share-based payment transactions, HKFRS 2 paragraph 10 requires an entity to measure the goods or services received, and the corresponding increase in equity directly, based on the fair value of the goods or services received, unless that fair value cannot be estimated reliably. On the other hand, HKFRS 2 paragraph 11 recognizes that it is difficult to estimate the fair value of services provided by an employee ("employee services") reliably and therefore requires the fair value of the services received to be measured by reference to the fair value of the equity instruments granted at the grant date, which is often referred as "grant date fair value". The fair value of employee services is recognized as an expense in profit or loss unless it qualifies for recognizing as an asset.

Review findings indicated that some members misunderstood HKFRS 2 as requiring share-based payment expenses to be recognized only when all vesting conditions are fulfilled. This had resulted in some entities not recognizing share-based payment expenses in the year during which share options had been granted. HKFRS 2 paragraph 20 states that *"<u>the entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary</u>, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements of paragraph 21"* (underline added).

"Vesting period" is defined in HKFRS 2 Appendix A as *"The period during which <u>all the specified vesting conditions</u> of a share-based payment arrangement are <u>to be satisfied</u>"* (underline added). A vesting period is the period between the grant date and the vesting date (i.e. the date that all vesting conditions are satisfied). If the instruments do not vest immediately, share-based payment expenses should be recognized <u>over the vesting period</u> in accordance with HKFRS 2 paragraph 20 instead of at the date when all vesting conditions are satisfied. Furthermore, whether the conditions are vesting or non-vesting and whether the conditions are market conditions would have different accounting implications under HKFRS 2. Therefore a careful assessment of the terms and conditions should be performed to properly identify the vesting period and the nature of those conditions. HKFRS 2 paragraph IG4A provides a flowchart to help determine the nature of the conditions (i.e vesting vs non-vesting and service vs performance). HKFRS 2 paragraph IG24 provides a table which categorizes, with examples, the various conditions that determine whether a counterparty receives an equity instrument granted and the accounting treatment of share-based payments with those conditions under HKFRS 2.

(i) Treatment of vesting conditions – service conditions or performance conditions

Vesting conditions are either service conditions or performance conditions. A performance condition might include a market condition.

Service conditions

As defined in HKFRS 2, a service condition is a vesting condition that requires the counterparty to complete a specified period of service to the entity.

A set of financial statements disclosed that the reporting entity has taken the "exit rate" of the employees to which share options have been granted into account in determining the "fair value of share options granted". There was no information about the nature of the exit rate and why such a rate had an impact on the grant-date fair value measurement of the share option. As further explained below, if the exit rate referred to a service condition under HKFRS 2, the inclusion of the rate as one of the factors for fair value measurement of the share options is not appropriate. An enquiry letter was therefore issued to draw the attention of the auditor of the reporting entity to our concerns.

It is not uncommon that share options granted to employees contain terms that require the employees to remain employed with the entity for a specified number of years before the share options are exercisable. As this condition is not related to the price or value of the entity's shares, it is not a market condition. Instead, it is a service condition (non-market condition) which shall be taken into account when estimating the number of share options that will vest as required by HKFRS 2 paragraph 19. However, a service condition does not affect the determination of the fair value of the share options. In contrast, a market condition shall be reflected in the fair value of the options and this will be further explained in (iii) below.

An entity must estimate the number of share options that are expected to vest in order to determine the amount of share-based payment expenses to be recognized over the vesting period. The amount recognized over the vesting period will be "trued up" as expectations change over that period up until the date that the options vest or fail to vest. Consequently, if non-market vesting conditions such as service conditions are not satisfied and so the options fail to vest then any amounts previously recognized in respect of those options will be fully reversed. We provide the following example to enable members to better understand and apply the above concepts.

100 share options were granted to 100 employees on 1 January 20x1 and the employees are required to remain with the entity for three years before the options vest. The options had a grant-date fair value of $3 each. It is expected that 5% of employees would leave the entity before the end of the vesting period.

In this example, the vesting period is the period from 1 January 20x1 (i.e. the grant date) to 31 December 20x3 (i.e. three years after the grant date). The share-based payment expense should be recognized over 20x1 to 20x3 (i.e. the vesting period). In 20x1, the share option expense to be recognized should be one-third of the grant date fair value of the share options multiplied by 95%. The share-based payment expense for 20x2 may be "trued up" depending on whether the number of options expected to vest had changed. In 20x3, the expense would be based on the number of options that actually vested based on the service condition, regardless of whether the options are eventually exercised. Please see the table below for further illustration:

Financial year	% of options expected to vest	Cumulative share-based payment expenses to be recognized at the end of the reporting period	Share-based payment expenses to be recognized in that financial year
20x1	95%	$3 X 100 options X 95% / 3 years = $95	$95
20x2	92% (Note 1)	$3 X 100 options X 92% / 3 X 2 = $184	$184 - $95 = $89
20x3	90% (Note 2)	$3 X 100 options X 90% = $270	$270 - $184 = $86

(Note 1) Assuming at the end of 20x2, management changes its estimation on the percentage of options expected to vest to 92%.

(Note 2) Assuming at the end of 20x3 (i.e. at the end of the vesting period), only 90% of the original employees still remain with the company.

If the service condition is not met at the end of 20x3, the share-based payment expense that had been recognized in 20x1 and 20x2 would be fully reversed in 20x3. Therefore, on a cumulative basis, no share-based payment expense is recognized for the employee services received if the share options do not ultimately vest as the service condition is not met.

Performance conditions

Performance conditions require the completion of a specified period of service and meeting specified performance targets. A performance target may be determined by reference to the entity's own operations or activities (e.g. achieving a specified growth in profit), or the price of the entity's equity instruments (e.g. reaching a specified increase in share price). Vesting conditions, other than market conditions, are not taken into account when estimating the fair value of the equity instruments (e.g. share options) granted (HKFRS 2 paragraph 19). Therefore performance conditions that are not market conditions are not considered in determining the grant date fair value.

(ii) Treatment of non-vesting conditions

As required by HKFRS 2 paragraph 21A, similar to market conditions, all non-vesting conditions shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognize the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (e.g. services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.

(iii) Measurement of fair value of equity instruments – market conditions

A reporting entity disclosed in its financial statements that the fair value of share options granted to its employees had taken into account the terms and conditions of the transactions, but excluded the conditions that were linked to price of shares of the reporting entity. However, as stated above, vesting conditions which are market conditions shall be reflected in the fair value of the share options.

For example, a vesting condition specifies that the share price of the reporting entity should reach a specified amount before the end of the specified service period in order for the options to vest. This vesting condition is a market condition as it relates to the price of the reporting entity's shares and therefore shall be considered in measuring the fair value of the share options. Under HKFRS 2, if the service condition is met at the end of the vesting period in the above example, the expenses recognized in 20x1 to 201x3 would not be reversed even if the market condition in the share options (e.g. the share price does not reach the specified amount in this example) is not met.

The above only sets out some key requirements of HKFRS 2 concerning the recognition and measurement of equity-settled share-based payment transactions involving employees. HKFRS 2 also covers complex areas such as share-based transactions amongst group entities and share-based transactions with cash alternatives (i.e. situations where the entity or other party can opt for settlement of transactions by issuing equity instruments or in cash). We recommend members read HKFRS 2 thoroughly and get an adequate understanding of HKFRS 2 in order to ensure that share-based payment transactions are properly accounted for based on the terms of the transactions.

2. HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Our 2010 annual report had discussed issues identified in relation to the accounting for non-current assets held for sale under HKFRS 5. However, similar issues were still identified in recent years. Therefore, we consider that there is a need to remind members of some key requirements of HKFRS 5.

HKFRS 5 sets out the requirements for the classification, measurement and presentation of non-current assets (or disposal groups) held for sale. We shall focus on classification and measurement issues:

a. Classification issues

Under HKFRS 5, a non-current asset (or a disposal group) shall be classified as "held for sale" if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. To meet this requirement, there are two conditions that must both be satisfied. The two conditions are that (i) the non-current asset (or disposal group) must be available for immediate sale in its present condition, subject to only terms that are usual and customary for sales of such assets (or disposal group); and (ii) its sale must be highly probable.

In a case reviewed, the reporting entity entered into a sale and purchase agreement with another entity whereby the reporting entity conditionally agreed to dispose of and the other entity conditionally agreed to purchase the entire equity interest of certain subsidiaries of the reporting entity. The relevant conditions were set out in the circular of the reporting entity and they had to be fulfilled on or before a specified date. The relevant subsidiaries to be disposed of in the above case were classified as a "disposal group held for sale" in the consolidated financial statements of the reporting entity.

The above case showed that the disposal was "conditional" on the satisfaction of some specified conditions. Further review revealed that the conditions set out in the circular were not usual or customary (e.g. the disposal was subject to completion of some restructuring that involved an external party) and that brought into question whether the disposal group was available for "immediate sale" in its "present condition", such that it was appropriate to classify it as "held for sale" under HKFRS 5.

In another example, the reporting entity received a notice from the government approximately 10 days before the year end. Following the receipt of the notice, a business line of the reporting entity ceased operations. The relevant assets and liabilities of the business line were grouped and presented as "assets classified held for sale" and "liabilities directly associated with assets classified as held for sale" in the consolidated statement of financial position of the reporting entity. However, given the short period between from the date of the notice and the year end date, we had questions how the assets related to the business line could have met the required conditions under HKFRS 5 in order to classify them as held for sale. We also had questions whether the assets related to the business line were assets to be abandoned due to the closure of the business. Under HKFRS 5 paragraph 13, a non-current asset (or disposal group) that is to be abandoned shall not be classified as held for sale. Non-current assets (or disposal groups) to be abandoned include non-current assets (or disposal groups) that are to be used to the end of the economic life and <u>those that are to be closed rather than sold</u>.

Some members believed, incorrectly, that as long as the entity has the intention to sell the asset (e.g. an investment property) within one year, the relevant non-current asset should be reclassified as a current asset held for sale. This is not appropriate. HKFRS 5 BC10 states that *"The Board noted that it had not intended that assets classified as non-current in accordance with IAS 1 Presentation of Financial Statements would be reclassified as current assets simply because of management's intention to sell or because they reached their final twelve months of expected use by the entity. The Board decided to clarify in IFRS 5 that assets classified as non-current are not reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with the IFRS. Further, assets of a class that an entity would normally regard as non-current and are acquired exclusively with a view to resale are not classified as current unless they meet the criteria to be classified as held for sale in accordance with the IFRS"* (underline added).

b. Measurement issues

HKFRS 5 paragraphs 15 to 29 set out the measurement requirements for non-current assets (or disposal groups) classified as held for sale. However, those measurement requirements do not apply to those non-current assets set out in HKFRS 5 paragraph 5 (e.g. deferred tax assets, assets arising from employee benefits, investment properties accounted for using the fair value model) as they shall continue to be measured in accordance with their applicable HKFRSs. The measurement requirements for disposal groups are similar to those for individual non-current assets held for sale but the accounting for disposal groups is complicated by the treatment of the assets included in the disposal groups that are outside the measurement scope of HKFRS 5.

(i) Measurement prior to classification as held for sale

The general principle is that the carrying amount(s) of the asset (or all the assets and liabilities in the disposal group) shall be measured in accordance with applicable HKFRSs, immediately before the initial classification of the asset (or the disposal group) as held for sale (HKFRS 5 paragraph 18).

(ii) Measurement on the date of classification as held for sale

On the date of classification as held for sale, the non-current asset or disposal group held for sale is measured at the lower of its carrying amount and fair value less costs to sell (HKFRS 5 paragraph 15). Therefore, an impairment review should be performed to identify any impairment of the non-current asset or disposal group held for sale. This is also consistent with the requirement of HKAS 36 paragraph 12(f) which specifies that an entity's plans to dispose of an asset is an internal impairment indicator that requires an impairment test to be performed. An impairment loss shall be recognized immediately (HKFRS 5 paragraph 20); and for a disposal group held for sale, the recognized impairment loss shall be allocated according to the order set out in HKAS 36 paragraphs 104(a) and (b) (i.e. first to the goodwill and then to the other assets on a pro-rata basis)(HKFRS 5 paragraph 23).

As mentioned in the IFRIC Update published by the IFRS Interpretations Committee ("Interpretations Committee") in January 2016, the Interpretations Committee received a request to clarify the extent that an impairment loss can be allocated to non-current assets within a disposal group. The Interpretations Committee confirmed that the amount of impairment that should be recognized for a disposal group would not be restricted by the fair value less costs of disposal or value in use of those non-current assets that are within the scope of the measurement requirements of IFRS 5. This means that a non-current asset measured under IFRS 5 can be measured at a lower amount than its recoverable amount under IAS 36. Members are advised to refer to this link (http://media.ifrs.org/2016/IFRIC/January/IFRIC-Update-January-2016.pdf) for details of the agenda decision made by the Interpretations Committee.

(iii) Subsequent measurement after classification as held for sale

HKFRS 5 paragraph 15 also applies to measurement subsequent to classification as held for sale. Therefore, the non-current asset or the disposal group held for sale shall be measured at the lower of its carrying amount and fair value less costs to sell at the end of each reporting period after classification as held for sale as long as the asset or group has not been disposed of.

Non-current asset held for sale

To meet the above requirement, the fair value less costs to sell of the non-current asset held for sale should be determined. If the carrying amount of the non-current asset held for sale exceeds its fair value less costs to sell, an impairment loss is recognized to reduce the carrying amount to fair value less costs to sell. A gain from any subsequent increase in fair value less costs to sell of the non-current asset held for sale shall be recognized <u>but not in excess</u> of the cumulative impairment loss that has been recognized in accordance with HKFRS 5 or previously in accordance with HKAS 36 (HKFRS 5 paragraph 21).

Disposal group held for sale

The requirements for remeasurement of a disposal group held for sale are similar to those for an individual non-current asset held for sale as discussed above. However, a point to note is that, on the subsequent remeasurement of a disposal group, the carrying amounts of assets and liabilities that are included in the disposal group but are excluded from the measurement requirements of HKFRS 5 due to the provisions in HKFRS 5 paragraph 5, shall be first remeasured in accordance with applicable HKFRSs "before" the remeasurement of the disposal group as a whole is carried out (HKFRS 5 paragraph 19). The disposal group as a whole is then remeasured to the lower of its carrying value (which is after adjustments to those assets and liabilities that are not covered by the measurement scope of HKFRS 5 but remeasured under their applicable HKFRSs) and fair value less cost to sell.

As the assets (or disposal groups) are expected to be recovered through sale rather than through use, an entity shall not depreciate (or amortize) the non-current assets held for sale or while they are part of a disposal group held for sale (HKFRS 5 paragraph 25).

A set of financial statements reviewed showed that the sale price subsequently agreed for the disposal group held for sale was much lower than the carrying amount of the net assets of the disposal group at the year end. It was questionable as to whether the reporting entity had properly measured the disposal group held for sale at the lower of its carrying amount and fair value less costs to sell.

We have discussed in an example above that a reporting entity classified its business line as held for sale following the receipt of the government notice. It was further noted that the assets related to the business line included an investment in an associate. However, the reporting entity continued to share the results of the associate. This did not comply with accounting standards. HKAS 28 (2011) *Investments in Associates and Joint Ventures* paragraph 20 requires that "*An entity shall apply HKFRS 5 to an investment, or a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale*". In this case, the investment in the associate, that was part of a disposal group held for sale, should be accounted for under HKFRS 5 and not by equity accounting under HKAS 28 (2011).

3. HKAS 12 *Income Taxes*

In our reviews, we identified deficiencies in deferred tax assessment on investment properties accounted for using the fair value model under HKAS 40 *Investment Property*.

HKAS 12 paragraph 51 requires that the measurement of deferred tax should be based on the tax consequences that would follow from the manner in which the entity expects to recover the carrying amount of its assets. However, HKAS 12 paragraph 51C provides a rebuttable presumption that an investment property that is measured using the fair value model is to be recovered entirely through sale. Enquiries on the application of HKAS 12 paragraph 51C were raised in some of our reviews. For example, an instance was noted that no deferred tax liabilities were recognized on the fair value gains of all investment properties located in different jurisdictions. It was unclear whether sufficient consideration had been given to the requirements of HKAS 12 paragraph 51C to support the conclusion that no deferred tax liabilities should be recognized for those investment properties.

Under the sale presumption provided in HKAS 12, the amount of deferred tax provided for investment properties that are accounted for using the fair value model depends on the tax rules on gains that apply on sale of such properties in the jurisdictions where the properties are located.

For investment properties located in Hong Kong where no capital gain tax is levied on a disposal of investment properties, the recognition of deferred tax liabilities for those investment properties would be limited to the tax effect of claw-back of depreciation allowances of the investment properties concerned, unless the rebuttable presumption is rebutted. According to HKAS 12 paragraph 51C, the presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. Members may refer the example under HKAS 12 paragraph 51C for more understanding of application of this Standard.

The rebuttable presumption as explained above also applies when a deferred tax liability or a deferred tax asset arises from measuring an investment property in a business combination if the entity uses the fair value model for subsequent measurement of that investment property (HKAS 12 paragraph 51D).

4. HKAS 28 (2011) *Investments in Associates and Joint Ventures*

The following summarized our review findings regarding the accounting for investments in associates. Some of them concern basic accounting concepts that remain unchanged after HKAS 28 *Investments in Associates* was superseded by HKAS 28 (2011) in 2013. The discussions set out in (b) and (d) below, though focusing on associates, are equally relevant to joint ventures when they are accounted for using the equity method of accounting under HKAS 28 (2011).

a. Consideration of potential voting rights in determining whether the investment is an associate

HKAS 28 (2011) *Investments in Associates and Joint Ventures* shall be applied by all entities that are investors with joint control of, or significant influence over, an investee (HKAS 28 (2011) IN3 and paragraph 2) and requires the investee to be accounted for using the equity method. Therefore it is important to properly establish that the entity has significant influence or joint control over the investee before applying the equity method of accounting. The relevant guidance on determination of significant influence in HKAS 28 *Investments in Associates* did not change when HKAS 28 (2011) was issued.

In a case reviewed, the reporting entity had investments in some convertible bonds which were issued by several different unlisted companies. The disclosures mentioned that the reporting entity had rights to convert the whole or part of the principal amount of the convertible bonds into shares at any time and from time to time before the maturity date. The reporting entity would hold more than 20% shareholding in the investees if the convertible bonds were fully converted. It was concluded that <u>in the opinion of directors</u>, the entity did not have significant influence over the financial and operating policies of the investees. However no disclosure was made to explain how the potential voting rights attributable to the convertible bonds were considered in reaching the conclusion that the reporting entity had no significant influence over the investees.

HKAS 28 (2011) paragraph 7 states that *"An entity may own share warrants, share call options, debt or equity instruments that are convertible into ordinary shares, or other similar instruments that have the potential, if exercised or converted, to give the entity additional voting power or to reduce another party's voting power over the financial and operating policies of another entity (ie potential voting rights). <u>The existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, are considered when assessing whether an entity has significant influence</u>. Potential voting rights are not currently exercisable or convertible when, for example, they cannot be exercised or converted until a future date or until the occurrence of a future event"* (underline added).

HKAS 28 (2011) paragraph 8 further states that *"In assessing whether potential voting rights contribute to significant influence, the entity examines all facts and circumstances (including the terms of exercise of the potential voting rights and any other contractual arrangements whether considered individually or in combination) that affect potential rights, except the intentions of management and the financial ability to exercise or convert those potential rights"* (underline added).

Based on the above requirements, an entity should identify any potential voting rights (e.g. those arising from any share options and convertible instruments) and consider their effects in particular whether such rights are currently exercisable or convertible when determining the degree of the investor's influence over the investee. However, management's intentions and the financial ability of the investor to exercise or convert the potential voting rights are not relevant for determining whether such rights contribute to significant influence. Therefore, in the above example, intentions of management or financial ability of the reporting entity to exercise the potential voting rights would not affect the conclusion that the reporting entity has significant influence so long as such rights are "currently" exercisable or convertible by the entity. Entities should carefully examine all facts and circumstances and identify any potential voting rights held by them and other parties before reaching the conclusion on whether significant influence exists or not. Judgment may be needed to apply in the process.

The significant judgment and assumptions made when an entity determines whether it has significant influence or control over the investee should be disclosed as required by HKFRS 12 *Disclosure of Interests in Other Entities*.

b. Sharing of losses of associates

We found a few instances in 2015 that the reporting entities had stopped recognizing their share of losses of the associates despite the carrying amount of the interests in associates including the related goodwill was still positive. The common observation about these entities is that the carrying amount of their interests in associates at the year end represented solely the goodwill relating to the associates. This treatment did not comply with the requirements of HKAS 28 (2011) as further explained below.

HKAS 28 (2011) paragraph 38 states that *"If an entity's share of losses of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further losses. The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture"* (underline added). HKAS 28 (2011) paragraph 32(a) also states that *"Goodwill relating to an associate or a joint venture is included in the carrying amount of the investment"* (underline added).

Under HKAS 28 (2011), the investment in an associate accounted for using the equity method comprised the investor's share of net assets of the associate; and the goodwill relating to the associate, if any. Our review findings revealed that some entities might not be aware of the particular guidance under HKAS 28 (2011) paragraph 38 that specifies that interests in associates include related goodwill. They have disregarded the element of goodwill that should have been included within the carrying amount of the interests in associates and ceased to share the losses of the associates once the associates had net liabilities.

The general principle of HKAS 28 (2011) is that an investor should share the losses of an associate until its interests, including goodwill and any long-term interests that in substance form part of its net investment, in that associate reach zero. If the associate subsequently reports profits, the investor shall resume recognizing its share of the associate's profits, but only after its share of the profits equals the share of losses that it previously did not recognize.

c. Different reporting periods between the reporting entity and the investee

HKAS 28 (2011) paragraph 34 states that *"When, in accordance with paragraph 33, the financial statements of an associate or a joint venture used in applying the equity method are prepared as of a date different from that used by the entity, adjustments shall be made for the effects of significant transactions or events that occur between that date and the date of the entity's financial statements. <u>In any case, the difference between the end of the reporting period of the associate or joint venture and that of the entity shall be no more than three months</u>"* (underline added).

A disclosure in a reporting entity's financial statements mentioned that the year end date of its joint ventures differed from that of the reporting entity and the interval between the two dates was more than three months. As stated, the difference between the end of the reporting period of joint venture and that of the reporting entity should not be more than three months. However, there was no information provided in the financial statements to explain how management justified the compliance with the above requirement. In its reply letter to our enquiry, the auditor clarified that for the purposes of applying the equity method of accounting, the reporting entity had obtained the management accounts of its joint ventures that were prepared for the same financial period as for the reporting entity. We noted that improvements have been made to the disclosures in the subsequent financial statements.

Members are reminded that, as required by HKAS 28 (2011) paragraph 33, if an associate or a joint venture uses a different reporting period from the one used by the reporting entity, the associate or joint venture should prepare, for the use of reporting by the investor, financial statements <u>as of the date of the investor's financial statements</u> unless it is impracticable to do so. When it is necessary to use the financial statements of an associate or a joint venture that has a year end date different from that of the investor, the investor then follows the steps set out in HKAS 28 (2011) paragraph 34 as quoted above but needs to pay attention that the time gap between the reporting dates cannot be more than three months.

d. Impairment assessment of interests in associates

Instances were identified where the carrying amount of the interests in listed associates significantly exceeded their market value at the year end. If this indicated that interests in associates may have been impaired, impairment assessment should have been carried out by the management of the reporting entity before arriving at the conclusion that no impairment loss should be recognized.

The guidance on the recognition and measurement of impairment losses on interests in an associate is provided in HKAS 28 (2011) paragraphs 40 to 43. In summary, after application of the equity method to recognize the associate's losses, the entity applies HKAS 39 *Financial Instruments: Recognition and Measurement* to determine whether it is necessary to recognize any additional impairment loss with respect to its net investment in the associate. If the entity identifies that its interests in the associate may be impaired after applying HKAS 39, the entire carrying amount of the interests in the associate (including goodwill) is then tested for impairment in accordance with HKAS 36.

5. HKAS 36 *Impairment of Assets*

HKAS 36 requires that an entity shall account for all assets (other than those set out in HKAS 36 paragraph 2) at an amount not more than their recoverable amount. When the carrying amount of an asset is more than its recoverable amount, the asset is impaired. The entity should recognize an impairment loss on the carrying amount. The common issues are whether management properly identifies impairment indicators to determine whether an impairment test is needed; and whether the recoverable amount is properly measured in the impairment test so as to determine an appropriate amount of impairment loss to be recognized. Our 2015 reviews identified deficiencies in these areas, some of which have been reported in previous years. We shall highlight below some instances encountered during our 2015 reviews.

a. A reporting entity provided impairment losses and reversed impairment losses on its different cash-generating units ("CGU") in the same operating segment over the past few years. This has caused the financial results of the entity to fluctuate significantly over those years. There was insufficient information provided in the financial statements to support the recognition and reversal of the impairment losses of those CGUs in the current and previous years, e.g. what indications had triggered the impairment assessments and their subsequent reversals.

b. A reporting entity recognized a full impairment loss on goodwill that was allocated to two different operating segments but none in the previous years. No information was provided in the financial statements to indicate that there were changes in circumstances of both segments in the current year.

c. A reporting entity used a growth rate of 8% in the cash flow projections for goodwill impairment assessment. However, the operating results of the CGU, to which the goodwill was allocated, had been declining for a number of years. There was no information to support that the growth rate of 8% was appropriate.

d. A reporting entity disclosed that an impairment loss on its assets was recognized based on a "fair value calculation". The basis for measuring the recoverable amount was unclear, i.e. whether it was value in use or fair value less costs of disposal. It was also unclear whether both value in use and fair value less costs of disposal had been determined such that the higher amount was taken as the recoverable amount for determining the amount of the impairment loss.

The above issues cast doubts on whether a proper impairment assessment has been performed as required by HKAS 36. For disclosure deficiencies, please refer to Section III below.

There are some relevant technical resources available in the Institute's website regarding impairment assessment. Members are advised to make use of them in order to better understand and apply the requirements of HKAS 36.

6. HKAS 38 *Intangible Assets*

According to HKAS 38 paragraph 57, an intangible asset arising from development (or from the development phase of an internal project) <u>shall be recognized</u> (i.e. not an accounting policy choice), <u>if and only if</u>, an entity can demonstrate:

- the technical feasibility of completing the asset;
- its intention to complete the asset;
- its ability to use or sell the asset;
- how the asset will generate probable future economic benefits;
- the availability of adequate technical, financial and other resources to complete the development and to use or sell the asset; <u>and</u>
- its ability to measure reliably the expenditure attributable to the asset during development.

Due to the nature of its business, a reporting entity invested significant research and development expenditure to develop new products. The financial statements of the reporting entity showed that all research and development expenditure incurred was charged into its income statement, resulting in no intangible assets being reported on its consolidated statement of financial position. As there was information in the annual report showing that there have been successful launches of new products by the reporting entity, it was questionable as to whether a proper assessment had been undertaken as required by HKAS 38 paragraph 57. In view of the significance of the potential financial impact, the auditor was therefore asked to explain how they were satisfied with the appropriateness of the reporting entity's accounting treatment of charging all research and development expenditure into its income statement.

The entity should capitalize the development expenditure as an intangible asset if all the above six criteria are satisfied. The auditor concerned explained that the reporting entity did not maintain a system to capture all its research and development expenditure attributable to each new product. However it was unclear whether the non-capitalization of development expenditure resulted from an internal control deficiency or it is a real inability of the reporting entity to measure reliably the expenditure attributable to each new product. The auditor should obtain further understanding about the costing system maintained by management and consider whether the development costs incurred are properly accounted for in accordance with HKAS 38.

Section III – Common disclosure deficiencies

We identified a number of disclosure deficiencies in the 2015 reviews. Some of them are new but some are recurring. Disclosure deficiencies relating to the application of HKFRS 7 *Financial Instruments: Disclosures*, HKFRS 8 *Operating Segments* and HKAS 24 (Revised) *Related Party Disclosures* have been extensively discussed in our previous years' reports and therefore we shall not cover them in this year's report. Our previous years' reports are available in the Institute's website:

http://www.hkicpa.org.hk/en/standards-and-regulations/quality-assurance/professional-standards-monitoring/publications-reference/

We shall highlight below some other common disclosure deficiencies identified in our review for this year:

1. HKFRS 3 (Revised) *Business Combinations*

   The following disclosures were often omitted or incomplete:

   - information about the nature and financial effect of a business combination (i.e. the information specified in HKFRS 3 paragraphs B64 to B66) that occurs after the end of the reporting period but before the financial statements are authorized for issue;

   - the amount of acquisition-related costs and, separately, the amount of those costs recognized as an expense and the line item or items in the statement of comprehensive income in which those expenses are recognized; and

   - a description of the reasons why the transaction resulted in a bargain purchase gain.

2. HKFRS 13 *Fair Value Measurement*

The following disclosures were often omitted or incomplete:

- information for each class of assets and liabilities measured at fair value in the statement of financial position after initial recognition e.g.:
  - for recurring and non-recurring fair value measurements,
    * the fair value measurement at the end of the reporting period;
    * the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2 or 3);
  - for recurring and non-recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a description of the valuation processes used by the reporting entity; and
  - for recurring fair value measurements categorized within Level 3 of the fair value hierarchy, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.

The objectives of the above disclosure requirements are to help users of financial statements assess the valuation techniques and inputs used to develop the measurements for the assets and liabilities that are measured at fair value; and the effect of the measurements on profit or loss for the period if the fair value measurements use significant unobservable inputs (Level 3). The above objectives would not be met if the disclosures are insufficient.

3. HKAS 1 (Revised) *Presentation of Financial Statements*

The following disclosures were often omitted or incomplete:

- the name of the parent and the ultimate parent of the group;
- summary quantitative data about what the reporting entity manages as capital;
- a presentation of a third statement of financial position as at the beginning of the preceding period if the reporting entity reclassifies items in its financial statements and that the reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period;
- information about (i) the assumptions that the reporting entity makes about the future, (ii) other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, and (iii) the details of the nature and carrying amount of the relevant assets and liabilities;

- comparative information in respect of the fair value hierarchy of non-financial assets;

- further subclassifications of reserves within equity into various classes, such as a revaluation reserve for available-for-sale investments and a revaluation surplus for owner-occupied properties.

Sometimes we noted that the categorization of items into those that will and will not be reclassified subsequently into profit or loss was not appropriate in the "other comprehensive income" section of the statement of profit or loss and other comprehensive income. For example, exchange differences arising on translation of foreign operations were grouped under the category of "items that may not be reclassified subsequently to profit or loss", which was not appropriate given that the relevant exchange reserve would have to be reclassified to profit or loss as required by HKAS 21 paragraph 48 on disposals of the foreign operations.

There were also occasions where the information disclosed in the financial statements was not consistent with the other information provided by the reporting entity e.g. announcements and circulars. Inconsistent information not only confused users of the financial statements but might also have an impact on the credibility of those financial statements. In this regard, we would expect that the auditors should have carried out appropriate procedures to obtain a sufficient understanding of the entity so that inconsistencies are identified and challenged.

4. HKAS 33 *Earnings per Share*

   The following disclosures were often omitted or incomplete:

   - instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future, but were not included in the calculation of diluted earnings per share because they are anti-dilutive for the period(s) presented (HKAS 33 paragraph 70(c)); and

   - information about changes in the number of ordinary or potential ordinary shares outstanding as a result of a capitalization, bonus issue, share split or a reverse share split and the fact that per share calculations reflected the changes in the number of shares (HKAS 33 paragraph 64).

5. HKAS 36 *Impairment of Assets*

   The following disclosures were omitted or incomplete:

   - information required by HKAS 36 paragraph 130(a) to (g) about an individual asset (including goodwill) or a cash-generating unit, for which an impairment loss has been recognized or reversed during the period, including

     - the recoverable amount of the asset (cash-generating unit);

     - if the recoverable amount is fair value less costs of disposal, the relevant information including the level of the fair value hierarchy within which the fair value measurement of the asset (cash-generating unit) is categorized in its entirety;

- if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use; and

- information required by HKAS 36 paragraph 134(a) to (f) about each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, including

  - the basis on which the unit's (group of units') recoverable amount has been determined (i.e. value in use or fair value less costs of disposal);

  - If the unit's (group of units') recoverable amount is based on value in use,

    * each key assumption on which management has based its cash flow projections;

    * a description of management's approach to determining the value(s) assigned to each key assumption;

    * the period over which management has projected cash flows based on financial budgets / forecasts approved by management;

    * the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets / forecasts;

    * the discount rate(s) applied to the cash flow projections;

  - if the unit's (group of units') recoverable amount is based on fair value less costs of disposal, the valuation techniques used; and

  - the information required by HKAS 36 paragraph 134(f) if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount.

Communication with members

The results of both programmes are used to assist members to improve their understanding and application of professional standards and raise the quality of auditing and financial reporting. More common and significant matters found in the review programmes were communicated to members through different channels:

- The QAD hosted two forums, in June and September 2015, that attracted a combined audience of approximately 500. The forums covered common findings from practice reviews and recommended actions to enhance audit quality. A webcast of the forum is available on the Institute's website until February 2017.

- The Director of the QAD ("the DQA") was invited by the Society of Chinese Accountants and Auditors to present in a seminar on the same topics covered in the Quality Assurance Forum in October 2015. The seminar attracted approximately 200 attendees.

- In November 2015, the QAD organized a joint forum with the FRC and HKEx which drew approximately 290 attendees. Common issues identified by the reviews of financial statements of Hong Kong listed companies carried out by the three bodies were presented. A webcast of the forum is available on the Institute's website until February 2017.

- The DQA participated in the practice review session of the 2015 SMP Symposium in November 2015 which attracted approximately 330 attendees.

- Two Financial Reporting and Auditing Alerts, No. 20 on auditor's report signing arrangement and No. 21 on provisional regulations on CPA practices carrying out audit services relating to the listing of Mainland enterprises outside the Mainland, were issued in 2015.

Findings from the reviews have also been used by the Institute's technical team to provide relevant support for members through regular technical training sessions.

Members of the Standards & Quality Accountability Board in 2015

Name	Position	Company
Ms. BROWN, Melissa	Chairman	Daobridge Capital
Ms. CHEUNG, Wing Han, Ivy (Appointed 27 January 2015)	Member	KPMG
Ms. CHUNG, Lai Ling, Ada	Member	Companies Registry, HKSAR
Mr. GRIEVE, Charles Ramsay	Member	Securities & Futures Commission
Mr. KENNEDY, Paul	Member	Hong Kong Exchanges and Clearing Limited
Mr. LAW, Cheuk Kin, Stephen (Appointed 27 January 2015)	Member	MTR Corporation Limited
Mrs. SENG SZE, Ka Mee, Natalia	Member	Tricor Services Limited
Mr. TEO, Wing On (Appointed 3 July 2015)	Member	Audit Commission, HKSAR
Mr. TONG, Chi Chiu, Alec (Appointed 18 June 2015)	Member	Henderson (China) Investment Co. Limited
Mr. WONG, Shing Hei, Charlix (Appointed 27 January 2015)	Member	The Treasury, HKSAR
Mr. Wong Tat-cheong, Frederick (Resigned 3 July 2015)	Member	Audit Commission, HKSAR

Members of the Practice Review Committee in 2015

Name	Position	Company
Mr. GEORGE, Richard John Weir	Chairman	Deloitte Touche Tohmatsu
Miss CHAN, Mei Bo, Mabel	Deputy Chairman	Mabel Chan & Co.
Mr. CHAN, Shu Kin, Albert	Member	Ting Ho Kwan & Chan
Miss CHAN, Wai Ching	Member	PricewaterhouseCoopers
Mr. FAN, Chun Wah, Andrew	Member	C.W. Fan & Co.
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Mr. KWONG, Kam Wing, Kelvin	Member	Grant Thornton
Mr. LAI, Tak Shing, Jonathan (Appointed 27 January 2015)	Member	HLB Hodgson Impey Cheng
Mr. LIU, Eugene	Member	RSM Nelson Wheeler
Mr. NG, Kar Ling, Johnny	Member	KPMG
Mr. OR, Ming Chiu	Member	Mazars CPA Limited
Mr. POON, Tsun Wah, Gary	Member	Poon & Co.
Miss TANG, Kwan Lai, Amingo	Member	SHINEWING (HK) CPA Limited
Mr. TSUI, Hon Man	Member	Crowe Horwath (HK) CPA Limited
Ms. YAM, Hoi Yin, Cecilia	Member	BDO Limited
Mr. YAU, Yin Kwun, Joseph	Member	C K Yau & Partners CPA Limited

Members of the Professional Standards Monitoring Expert Panel in 2015

Name	Position	Company
Ms. CHEUNG, Sau Ying, Olivia	Member	Hong Kong Exchanges and Clearing Limited
Mr. CHOW, Siu Lui, Jack	Member	VMS Investment Group
Mr. DEALY, Nigel Derrick	Member	PricewaterhouseCoopers
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Mr. HO, Che Kong, John	Member	Leighton Asia Limited
Miss HSIANG, Yuet Ming, Fanny	Member	BDO Limited
Mr. LAI, Tak Shing, Jonathan (Appointed 27 January 2015)	Member	HLB Hodgson Impey Cheng
Mrs. MORLEY, Catherine Susanna	Member	KPMG
Mr. PANG, Wai Hang, Arthur	Member	SHINEWING (HK) CPA Limited
Mr. TAYLOR, Stephen	Member	Deloitte Touche Tohmatsu
Mr. YAN, Yiu Kwong, Eddy	Member	Crowe Horwath (HK) CPA Limited

Hong Kong Institute of Certified Public Accountants
37th Floor, Wu Chung House
213 Queen's Road East, Wanchai, Hong Kong
Tel: (852) 2287 7228
Fax: (852) 2865 6603
Email: hkicpa@hkicpa.org.hk
Website: www.hkicpa.org.hk

908r3_20160323