



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



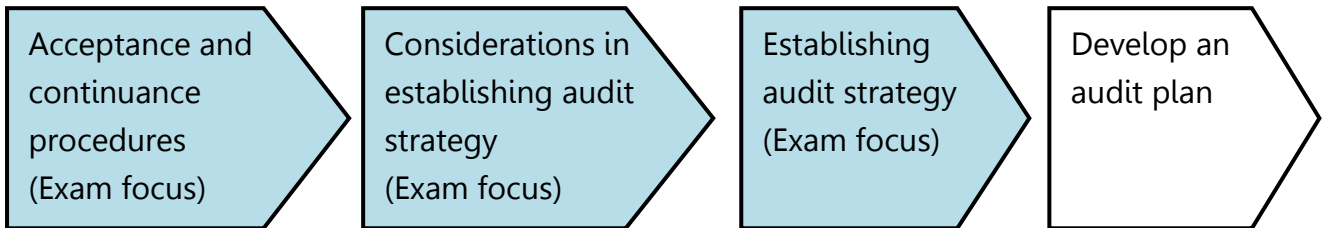
**Module Preparation Seminar (Part II)**  
**for**  
**Module C on Business Assurance**

**Speaker**  
**Mr. Taky Lo**

**31 October 2013**

**Responses to Assessed Risks (HKSA 330 (Clarified))**

**Planning - Risk Assessment and Establishing Audit Strategy**  
**HKSA 300 "Planning an Audit of Financial Statements"**

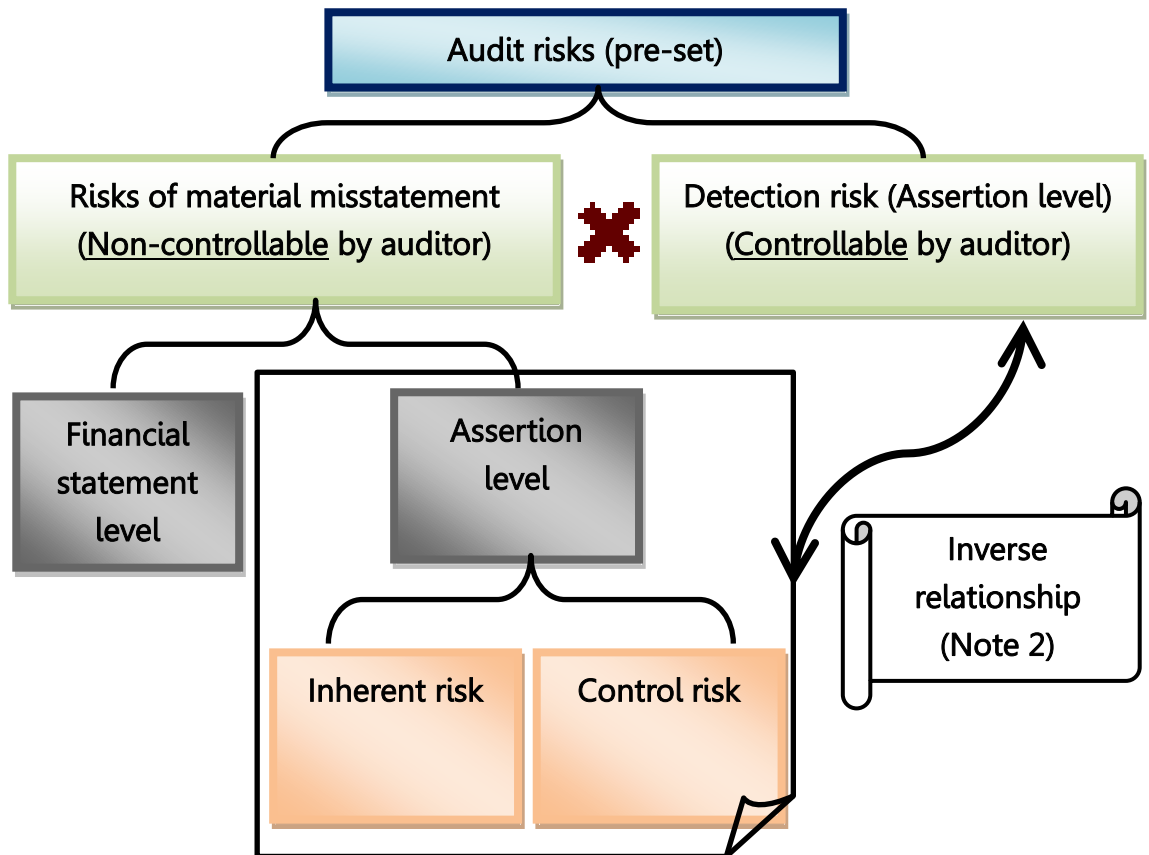


① **Considerations in establishing audit strategy**

In the Appendix of HKSA 300, there is a prolonged list stating the examples of matters to consider when establishing the overall audit strategy. Among the examples of considerations, there are **two broad areas** which are **focused in the examination**:

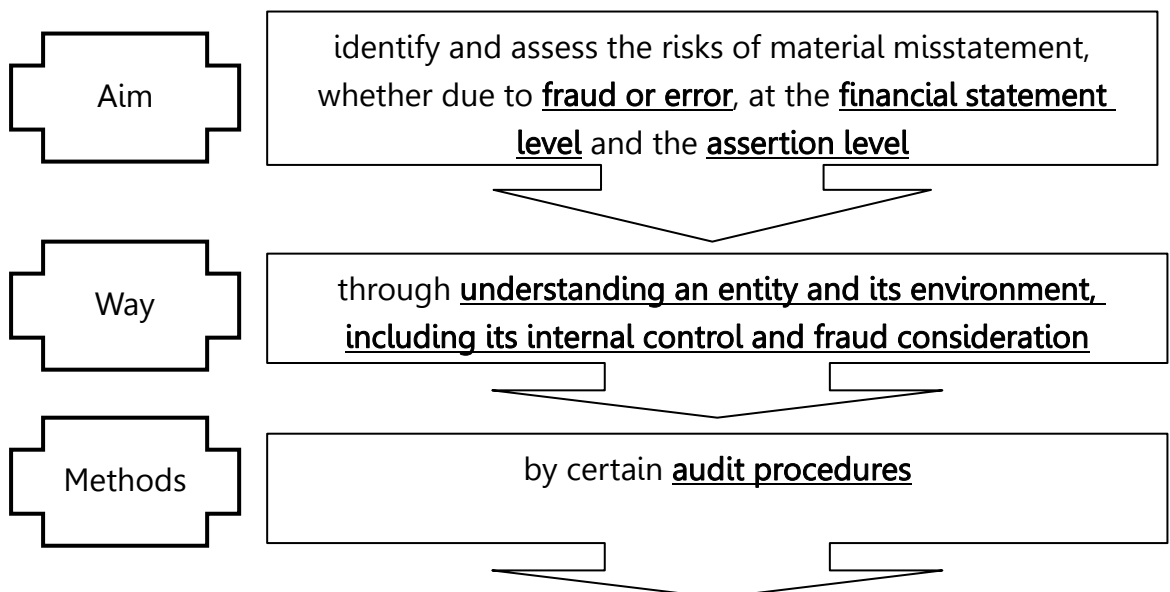


① Identification and Assessment of Risks of Material Misstatement



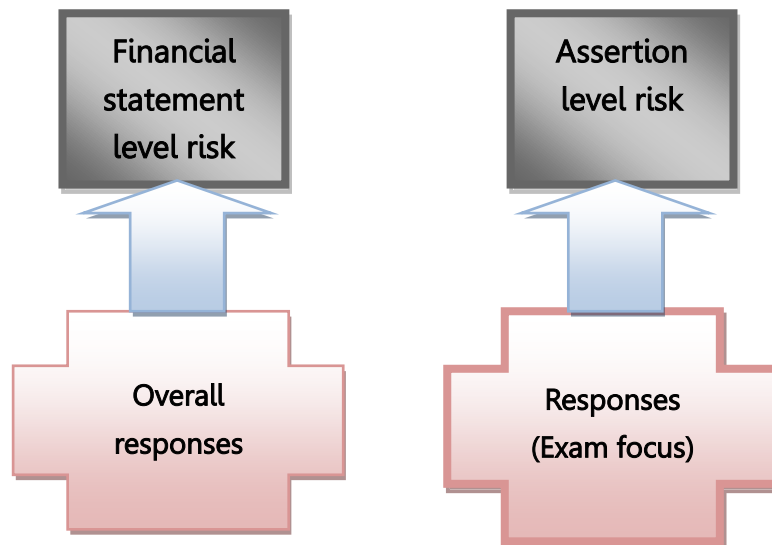
**HKSA 315 (Revised) "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment"**

Risk assessment procedures are the audit procedures to [HKSA 315R.4 (extracted)]:



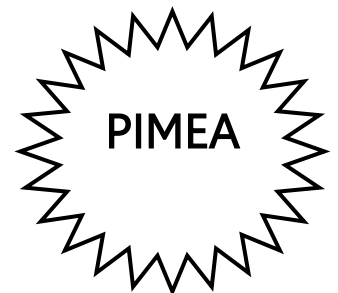
② **Establishing audit strategy**

**HKSA 330 "The Auditor's Responses to Assessed Risks"**



**Overall responses to financial statement level risk**

- P ⇒ **P**roviding more supervision
- I ⇒ **I**ncorporation of unpredictability elements🌀
- M ⇒ **M**aking general changes to NET of audit procedures
- E ⇒ **E**mphasizing the need of professional skepticism📖
- A ⇒ **A**ssigning more experienced staff to the engagement



🌀 For example:

- Performing substantive audit procedures on selected account balances and assertions not otherwise tested due to their materiality or risk;
- Adjusting the timing of audit procedures from that otherwise expected;
- Using different sampling methods; or
- Performing audit procedures at different locations or at locations on an unannounced basis [HKSA 240.A36 (extracted)].

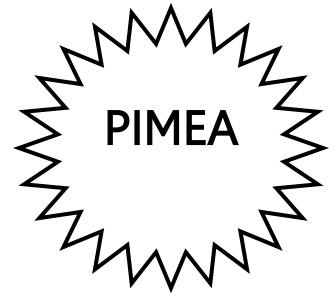
📖 Professional skepticism is an attitude that includes a **questioning mind**, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence [HKSA 200.13].

However, the auditor may accept records and documents **as genuine unless** the auditor has reason to believe the contrary, in which the auditor is required to investigate further and determine what modifications or additions to audit procedures are necessary to resolve the matter [HKSA 220.A21 (extracted)].



*Overall responses to financial statement level risk due to fraud*

- P ⇒ Providing more supervision
- I ⇒ Incorporation of unpredictability elements
- M ⇒ Making general changes to NET of audit procedures
- E ⇒ Evaluate the selection and application of accounting policies, particularly those subjective and complex transactions
- A ⇒ Assigning more experienced staff to the engagement



February 2008 Question 1

**CASE**

Hong Kong Printing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Printing Company Limited and its subsidiaries ("HKP") are principally engaged in the manufacture and printing of multi-colour packing products, boxes, books, brochures and other paper products. All HKP's production facilities are located in Mainland China.

**Question 1** (13 marks - approximately 23 minutes)

You are performing certain preliminary engagement activities for the audit of HKP's financial statements for the year ended 31 December 2007 ("2007 audit"), including the development of an overall audit strategy, and an assessment of the risk of material misstatement at the financial statement level.

**Required:**

**Determine:**

- (b) the overall response and any relevant audit procedures in response to your preliminary assessment that the risk of material misstatement at the financial statement level due to fraud and error is low.

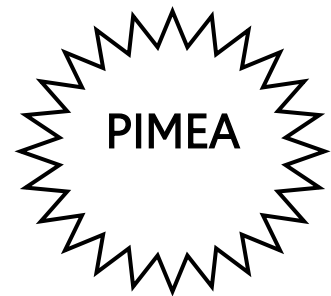
(7 marks)

**Question 1(b)**

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

*Overall responses to financial statement level risk due to fraud*

- P ⇒ Providing more supervision
- I ⇒ Incorporation of unpredictability elements
- M ⇒ Making general changes to NET of audit procedures
- E ⇒ Evaluate the selection and application of accounting policies, particularly those subjective and complex transactions
- A ⇒ Assigning more experienced staff to the engagement



P ⇒ Providing more supervision

A ⇒ Assigning more experienced staff to the engagement

👉 [XYZ & Co.] can assign and supervise personnel taking account of the knowledge, skill and ability of the individuals to be given significant engagement responsibilities and the auditor's assessment of the risks of material misstatement due to fraud for the engagement.

I ⇒ Incorporation of unpredictability elements

M ⇒ Making general changes to NET of audit procedures

👉 [XYZ & Co.] can incorporate unpredictability elements and change the nature, timing and extent of certain audit procedures, such as:

- 👉 performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk;
- 👉 adjusting the timing of audit procedures from that otherwise expected;
- 👉 using different sampling methods; or
- 👉 performing audit procedures at different locations or at locations on an unannounced basis.

E ⇒ Evaluate the selection and application of accounting policies, particularly those subjective and complex transactions

👉 [XYZ & Co.] can evaluate whether the selection and application of accounting policies by the entity, particularly those related to subjective measurements and complex transactions, may be indicative of fraudulent financial reporting resulting from management's effort to manage earnings.

*The planned answers seem reasonable and should get high scores?  
Sorry, totally NO marks given for this requirement!!!*

**Answer 1(b)**

The risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

However, HKSA 240 requires responses on FS level due to fraud, **disregard the level of RMM!**

In general, no particular response is required for a low assessed risk of material misstatement at the financial statement level, except that the engagement team should continue to maintain professional scepticism in gathering and evaluating audit evidence.

However, HKSA 240 “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements” recognises that management is in a unique position to perpetrate fraud because of management’s ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Therefore, even if the engagement team assessed the risk of material misstatement at the financial statement level due to fraud as low, the engagement team is required to perform audit procedures to respond to the (presumed) risk of management override of controls.

Totally **can't relate** the answers with the requirements!

These audit procedures may include:

- (1) the analytical review of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements to determine whether they are appropriate;
- (2) the analytical review of accounting estimates for biases that could result in material misstatement due to fraud; and
- (3) making enquiries of HKP’s management to obtain an understanding of the business rationale for significant transactions, if any, that are outside of HKP’s normal course of business or that otherwise appear to be unusual.

Examiners' report

Question 1(b) – 7 marks

The question required candidates to determine the overall response to a financial statement level risk which was assessed as low, and any specific audit procedures to perform. Generally, candidates' performance in this part was poor, although some good candidates scored full mark. This might be because this way of posing the question had not appeared in past examinations. Many candidates scored low mark mainly because they copied irrelevant materials from the CLP or past examination papers to explain how financial statement level risks were assessed.

Most of the candidates did not refer to the presumed risk of management override even if the financial statement level risk was assessed as low and hence failed to refer to the mandatory procedures required by the auditing standards. Many candidates blindly copied materials from the CLP the procedures to assess the risk of fraud, disregarding the given fact that the risk had already been assessed as low.

**December 2010 Question 2**

**CASE**

Day and Night (D&N) is a firm of Certified Public Accountants (Practising) and has recently been approached by A Dummy Limited (ADL) in respect of a change of its statutory auditor. In considering the audit nomination, D&N has been given the audited financial statements for the year ended 31 March 2009 and the unaudited management accounts for the 9-month period ended 31 December 2009, of which certain key figures are detailed as follows:

**ADL's statement of comprehensive income**

	<b>Unaudited management accounts (9 months ended 31 December 2009)</b>	<b>Audited financial statements (Year ended 31 March 2009)</b>
	<b>HK\$'000</b>	<b>HK\$'000</b>
Revenue	103,985	152,495
Gross profit	30,294	49,493
Profit before tax	10,604	16,956

**ADL's statement of financial position**

	<b>Unaudited management accounts (at 31 December 2009)</b>	<b>Audited financial statements (at 31 March 2009)</b>
	<b>HK\$'000</b>	<b>HK\$'000</b>
Non-current assets	106,166	94,507
Current assets	78,324	73,611
Current liabilities	(79,302)	(74,247)
Non-current liabilities	(10,958)	(10,245)

ADL is a private company in the business of producing Chinese nutritious food and was established by its owner, Mr. Chan, about twenty years ago. Mr. Chan, aged 70, is still active in running ADL, but he would like to retire in the next two to three years. As none of Mr. Chan's children is interested to succeed him in running the business, he would like to sell ADL to some business partners or investors. Mr. Chan has not yet decided on the most appropriate form of partnership or capitalisation arrangement, but he has plans to utilise any funding injection as the company's working capital. Some institutional investors have already expressed their interest and have made some enquiries about the company's business.



There was a longstanding lawsuit against ADL at the High Court in respect of a violation of some intellectual property rights. ADL lost the case in November 2009 and was ordered to pay compensation of HK\$50,000,000. The compensation has not yet been paid. A provision of HK\$30,000,000 has been made in the financial statements and management accounts. Mr. Chan is in discussion with the lawyers regarding an appeal against the judgement.

Mr. Chan has asked D&N to consider charging the audit fee based on the amount of ADL's reported profit for the year ended 31 March 2010.

**Question 2** (9 marks – approximately 16 minutes)

Assume that D&N has accepted the audit engagement. Nancy is D&N's engagement partner on ADL's audit and has made an assessment of the risk of material misstatement at the financial statement level due to fraud as low.

**Required:**

- (a) **Define** the risk of material misstatement at the **financial statement level**. (1 mark)
- (b) As the audit manager of D&N, explain to your trainees:
- (i) **how** Nancy's assessment of the risk of material misstatement at the **financial statement level** **due to fraud** as low was formed; and
  - (ii) D&N's **overall response** and the relevant audit procedures in response to such assessment.
- (8 marks)

**Part (a)**

Risk of material misstatement at the financial statement level refers to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

1

### Part (b)(i)

You may be a little bit **confused** on how to explain "how" in this part. However, this part just worths **4 marks** therefore the examiner does **NOT** expect you to apply the information in the case to support the partner's view that the fraud risk is assessed to be low. You only need to explain the broad concept about **how to assess the financial statement level risk** and **fraud risk** according to HKSA.

#### ① Financial statement level risk

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

1

⇒ Nancy has [identified and assessed the risks of material misstatement, whether due to **fraud or error**, at the **financial statement level** and the **assertion level** through **understanding an entity and its environment**, including its internal control and fraud consideration.]

1

#### ② Fraud risk

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

1

⇒ Nancy has performed the procedures to obtain information for use in identifying the risks of material misstatement due to fraud, including **evaluation of fraud risk factors**, **identifying any unusual relationship in ADL** and **inquiring** the management and those charged with governance about any existence of fraud.

### Part (b)(ii)

D&N's overall response to such assessment is:

- 👉 **[Providing more supervision]** to the **audit engagement team of ADL**
- 👉 **[Incorporation of unpredictability elements]** during the **audit process of ADL**
- 👉 **[Making general changes to NET of audit procedures]** during the **audit process of ADL**
- 👉 **[Evaluate the selection and application of accounting policies, particularly those subjective and complex transactions]**
- 👉 **[Assigning more experienced staff to ADL's engagement]**

1

### **Answer 2(b)**

Nancy's assessment was formed based on HKSA 315 (Clarified) "Understanding the Entity and its Environment and Assessing the Risks of Misstatement" which require an understanding of ADL and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

In addition, HKSA 500 (Clarified) "Audit Evidence" requires Nancy to use assertions in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures.

In general, D&N is not required to give any particular response for a low risk assessment in the risk of material misstatement at the financial statement level, other than maintaining a professional scepticism in gathering and evaluating audit evidence.

HKSA 240 (Clarified) "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" states that:

Management is in a unique position to perpetrate fraud because of management's ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

Accordingly, even if Nancy assessed the risk of material misstatement at the financial statement level due to fraud as low, D&N should perform audit procedures in responding to the (presumed) risk of management override of controls.

**WHY?**

The relevant audit procedures in response to Nancy's assessment are to:

- test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;
- review accounting estimates for biases that could result in material misstatement due to fraud; and
- obtain an understanding of the business rationale of significant transactions that D&N becomes aware of that are outside of ADL's normal course of business or that otherwise appear to be unusual.

**WHY?**



Examiners' report

Question 2(a) – 1 marks

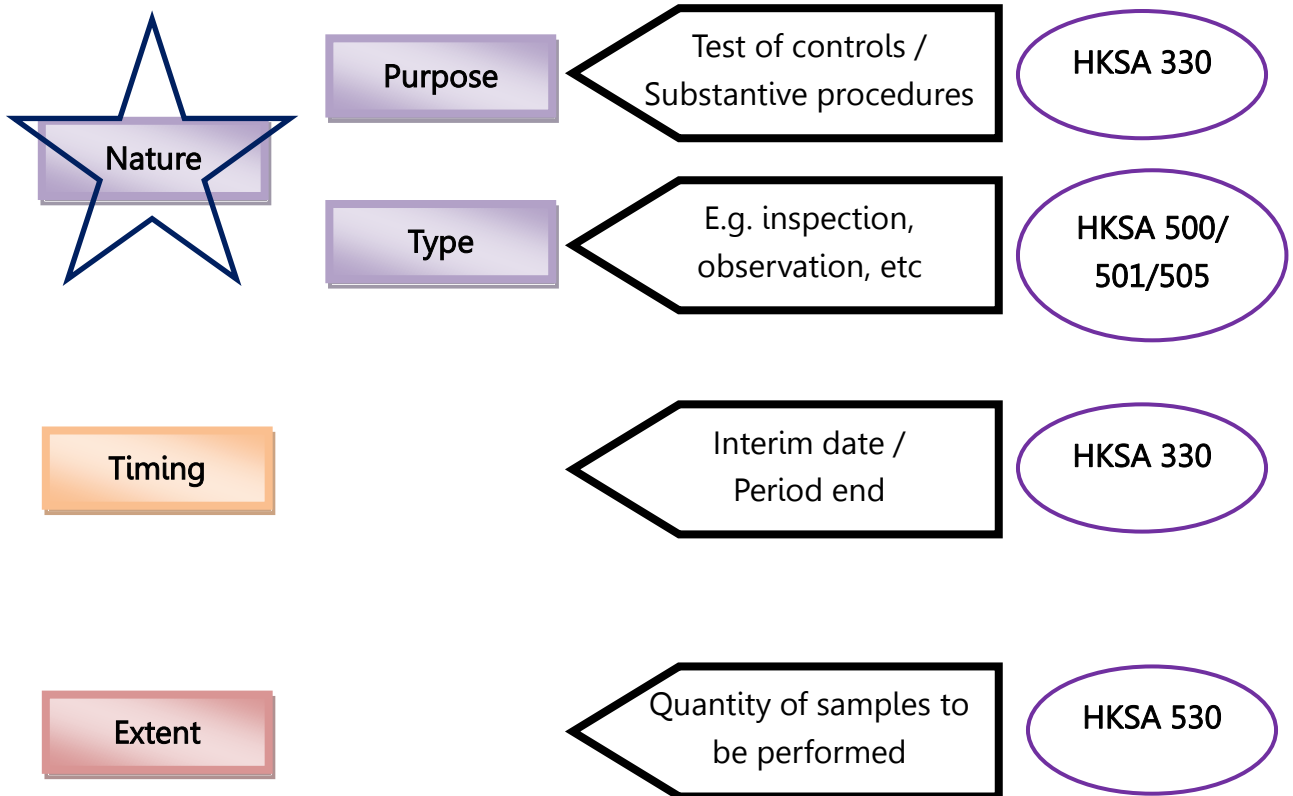
This 1-mark question required candidates to provide a straightforward definition of the risk of material misstatement at the financial statement level. Not surprisingly, most of the candidates did well.

Question 2(b) – 8 marks

This question required candidates to explain two matters: (i) how an assessment of the risk of material misstatement as low at the financial statement level due to fraud was formed; and (ii) the overall response and audit procedures in response to such an assessment. Candidates' performance in this question was below average. Too many candidates did not address the specific issues in the question and were not able to quote from the relevant standards.

**Responses to assertion level risk**

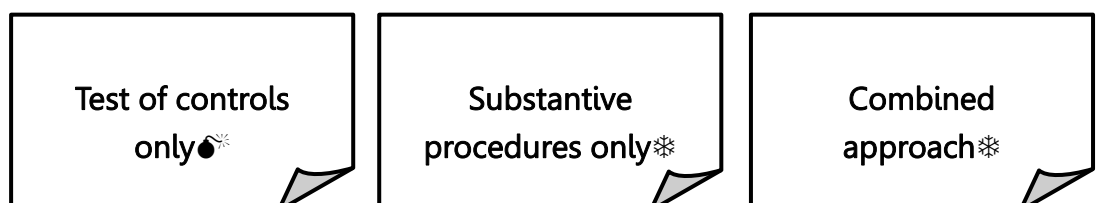
The auditor shall design the nature, timing and extent of further audit procedures ("NET") and perform those procedures that are responsive to the assessed risks of material misstatement at each assertion of account balances, classes of transactions and disclosures [HKSA 330.6 (extracted)].



① **Nature of further audit procedures**

☞ **Purpose**

For each assertion of account balances, classes of transactions and disclosures, the auditor can determine the purpose of the further audit procedures in three different categories [HKSA 330.A4 (extracted)]:



☞ Type

HKSA 500 "Audit Evidence"

I ⇒ Inquiry  
R ⇒ Recalculation  
AP ⇒ Analytical Procedures  
R ⇒ Reperformance  
O ⇒ Observation  
C ⇒ Confirmation ☒  
I ⇒ Inspection



☒ HKSA 505 "External Confirmations"

What  
information?

Who to receive?

How to set the  
respond method?

What information?

- account balances and their elements;
- terms of agreements, contracts, or transactions between an entity and other parties; or
- absence of certain conditions, such as side agreement [HKSA 505.A1 (extracted)]

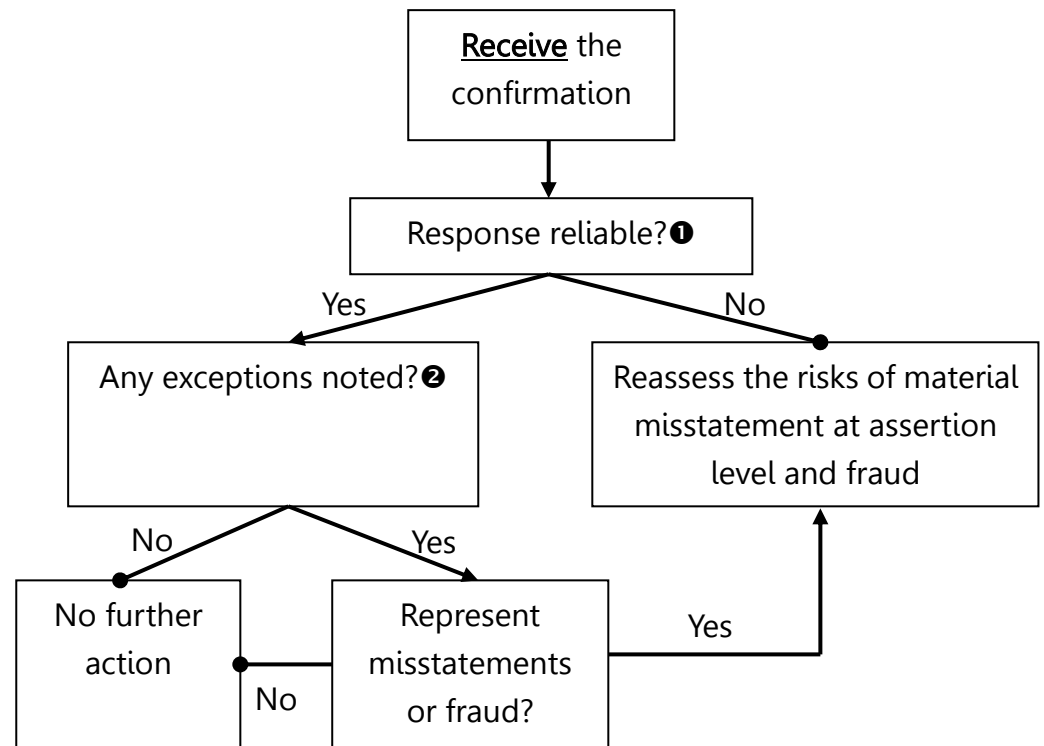
Who to receive?

Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is **knowledgeable about the information to be confirmed**. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation [HKSA 505.A2].

*How to set the respond method?*

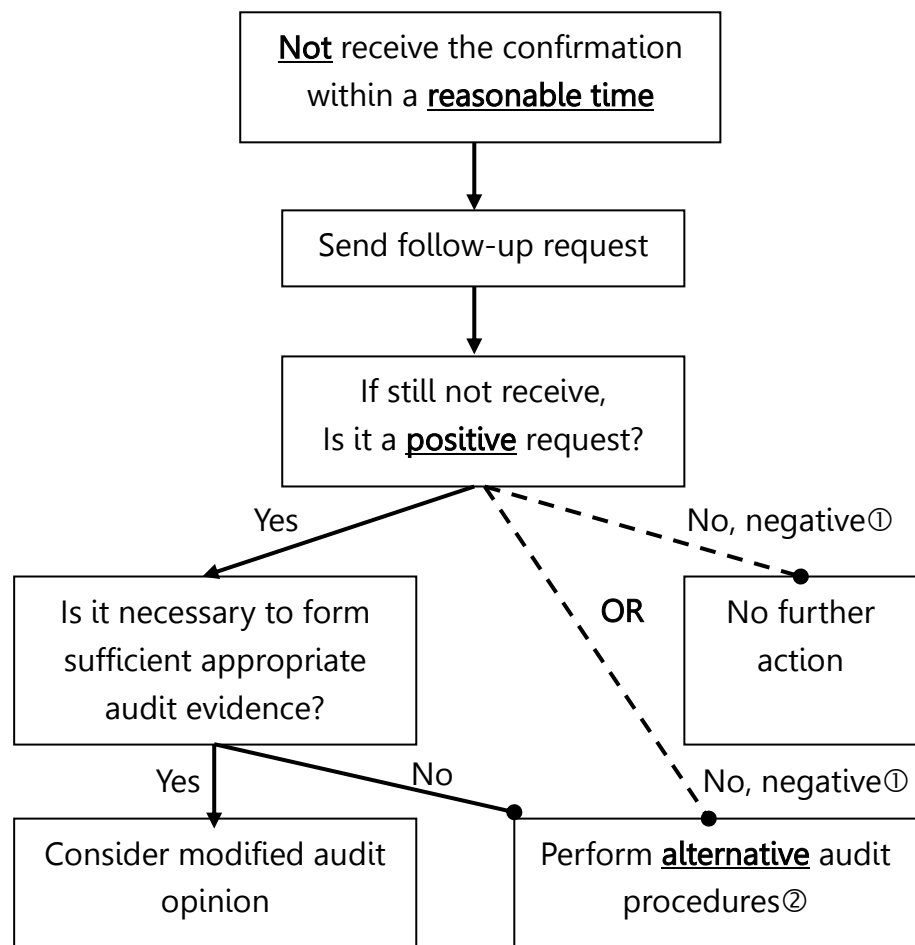
		<b>Positive request</b>	<b>Negative request</b>
1.	Definition	A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.	A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
2.	When to use	Positive confirmation request should normally be regarded as the <b>standard</b> request format of external confirmations.	Can be used as the <b>sole</b> substantive audit procedures if <b>all</b> of the following applies: <ul style="list-style-type: none"> <li>- Lower risk of material misstatement and controls operating effectively to a particular assertion;</li> <li>- Large and homogenous populations</li> <li>- Very low exception rate; and</li> <li>- The recipients would reasonably not to disregard the requests [HKSA 550.15]</li> </ul>

*The logical flow of the follow-up actions after sending out the external confirmations:* [HKSA 505.10-14, A7, A11-A23]



- ① Situations that may indicate doubts about the reliability of a response include:
- Confirmations were received by the auditor indirectly, for example, through clients;
  - Confirmations were not from the intended confirming party [HKSA 505.A11 (extracted)]; or
  - Confirmations were received through facsimile or electronic mail but the electronic environment is not secure [HKSA 505.A12 (extracted)].

- ② Some exceptions do not represent misstatements. For example:
  - the auditor may conclude that differences in responses to confirmation requests are due to **timing, measurement, or clerical errors** in the external confirmation procedures [HKSA 505.A22];
  - payments made by the customer before the confirmation date but received by client shortly after the confirmation date [HKSA 530.A6 (extracted)]; or
  - Misposting between customer accounts but no effect on total account receivables balances [HKSA 530.A6 (extracted)].



① The failure to receive a response to a negative confirmation request does not explicitly indicate receipt by the intended confirming party of the confirmation request or verification of the accuracy of the information contained in the request [HKSA 505.A23 (extracted)]. Therefore, except for the rare circumstance stated above that negative confirmation serves to be the sole substantive audit procedure, normally other audit substantive procedures (e.g. inspect the necessary documents) should have been performed together with sending the negative confirmation.

② For example: [HKSA 505.A18 (extracted)]

<u>Accounts</u>	<u>Examples of alternative procedures</u>
Trade receivable / payables	- Inspect subsequent settlements - Inspect shipping documents - Inspect customers' / suppliers' statements - Perform cut-off test
Bank balances	- Inspect bank statements and deposit slips

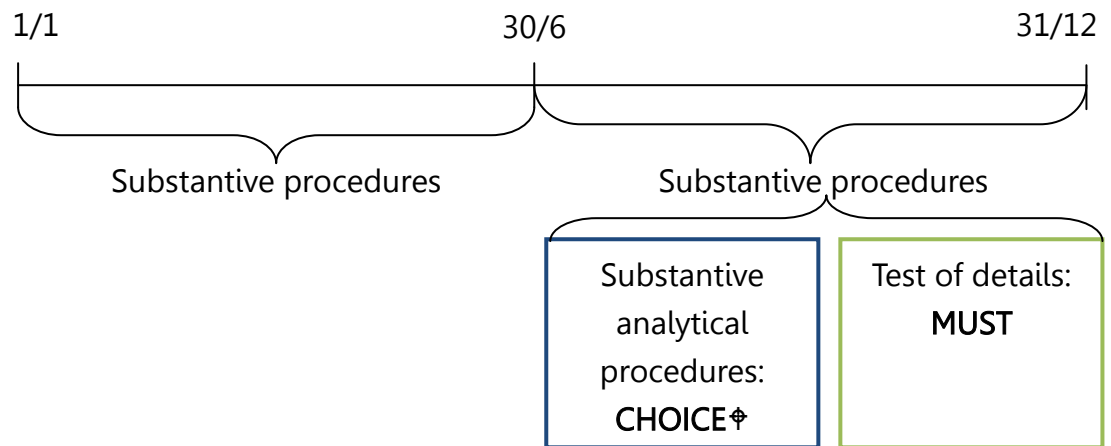
② **Timing of further audit procedures**

☞ Timing of tests of controls

- only to a point in time, for example, when testing controls over the entity's physical inventory counting at the period end;
- over a period of time [HKSA 330.A32 (extracted)]; or
- rely on the results of the previous audits.

☞ Timing of substantive procedures

Usually, substantive procedures will be performed at period end. If substantive procedures are performed at an interim date:



③ Extent of further audit procedures

When designing test of controls and test of details in substantive procedures, the auditor shall determine the following available means to the auditor for selecting items for testing [HKSA 500.A52]:

		<u>Test of controls</u>	<u>Substantive procedures - Test of details</u>
1.	Selecting all items (100%)	✘	✔
2.	Selecting specific items	✔ / ✘	✔
3.	Audit sampling 📖	✔	✔



 **HKSA 530 "Audit Sampling"**

**May 2009 Section A**

**CASE**

Hong Kong Manufacturing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Manufacturing Company Limited and its subsidiaries ("HKM") are principally engaged in the manufacture and distribution of garment and apparel products. All HKM's production facilities are located in Mainland China. HKM's operating results in the last five years are summarised as follows:

	2008 HK\$m (Draft)	2007 HK\$m	2006 HK\$m	2005 HK\$m	2004 HK\$m
Revenue	3,322	2,488	2,045	1,368	975
Operating profit	400	353	349	167	56
Profit after tax	335	283	255	132	33

The draft summary of the financial position of HKM as at 31 December 2008 is as follows:

	2008 HK\$m	2007 HK\$m
Intangible assets	150	52
Property, plant and equipment	547	446
Other non-current assets	42	86
Inventories	486	282
Trade and other receivables	704	479
Bank balances and cash	580	567
Other current assets	106	36
<b>Total Assets</b>	<b>2,615</b>	<b>1,948</b>
Equity	1,903	1,556
Long-term bank loans	14	7
Taxation payable	79	49
Bank overdrafts	68	11
Trade and bills payable	377	228
Accruals and other payables	174	97
<b>Total Equity and Liabilities</b>	<b>2,615</b>	<b>1,948</b>

You are a manager at XYZ & Co., HKM's auditor since its listing in 2006. You are the manager-in-charge of the audit of HKM's financial statements for the year ended 31 December 2008.

**Question 2 (13 marks - approximately 24 minutes)**

Your team assessed the inherent risks of material misstatement at the assertion level of revenue from sales of goods as normal for all assertions and were able to rebut the presumed risk of fraud in revenue recognition. After taking into consideration the design and implementation of HKM's internal controls over revenue transactions, your team assessed the risks of material misstatement at the assertion level as low for all assertions with an expectation of the operating effectiveness of the internal controls. You instruct your assistants to perform tests of details on a sample of sale transactions for the occurrence of sale transactions, concurrently with tests of controls on revenue transactions to confirm your team's expectation of the operating effectiveness of the internal controls.

**Required:**

- (a) Determine **how the sample size for the tests of details** would be affected:
- (i) by **audit materiality** at a given level of assessed risk; and
  - (ii) the **assessed low risk** at a given level of audit materiality.

(6 marks)

**HKSA 530 "Audit Sampling"**

**Examples of Factors Influencing Sample Size for Tests of Details**

The following are factors that the auditor may consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the auditor does not modify the approach to tests of controls or otherwise modify the nature or timing of substantive procedures in response to the assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE	
1. An increase in the auditor's assessment of the risk of material misstatement	Increase	The higher the auditor's assessment of the risk of material misstatement, the larger the sample size needs to be. The auditor's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the auditor does not perform tests of controls, the auditor's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the auditor needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease	The more the auditor is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular population, the less assurance the auditor will require from sampling and, therefore, the smaller the sample size can be.
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase	The greater the level of assurance that the auditor requires that the results of the sample are in fact indicative of the actual amount of misstatement in the population, the larger the sample size needs to be.
4. An increase in tolerable misstatement	Decrease	The lower the tolerable misstatement, the larger the sample size needs to be.
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase	The greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual

4

2

**Answer 2(a)**

An increase in audit materiality increases the total error that the auditor is willing to accept.

Therefore, at a given level of assessed risk, an increase in the audit materiality level in the revenue of HKM will reduce the sample size for the tests of details.

At a given level of audit materiality, a reduction in the auditor's assessment of the risk of material misstatement will reduce the sample size.

Provided that the engagement team is satisfied that assessed risks of the relevant assertions of revenue were low, for example by performing appropriate tests of controls to obtain evidence of the operating effectiveness of the controls during the period, the extent of tests of details, i.e. the sample size, could be kept to a minimum.

**Examiners' report**

**Question 2(a) – 6 marks**

Many candidates performed quite well in this question in terms of how the sample size would be affected, but some focused only on quoting the provisions under HKSA 530 and did not provide valid answers.



Overall responses to assertion level risk due to fraud

**Specific Responses—Misstatement Resulting from Fraudulent Financial Reporting**

Examples of responses to the auditor's assessment of the risks of material misstatement due to fraudulent financial reporting are as follows:

*Revenue Recognition*

**Rebuttable presumed fraud risk!**

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cutoff procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

### *Inventory Quantities*

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked (for example, hollow squares) or labeled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts – for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

### *Management Estimates*

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

### **Specific Responses—Misstatements Due to Misappropriation of Assets**

Differing circumstances would necessarily dictate different responses. Ordinarily, the audit response to an assessed risk of material misstatement due to fraud relating to misappropriation of assets will be directed toward certain account balances and classes of transactions. Although some of the audit responses noted in the two categories above may apply in such circumstances, the scope of the work is to be linked to the specific information about the misappropriation risk that has been identified.

Examples of responses to the auditor's assessment of the risk of material misstatements due to misappropriation of assets are as follows:

- Counting cash or securities at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analyzing inventory shortages by location or product type.
- Comparing key inventory ratios to industry norm.

- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analyzing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorization and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

(Source: HKSA 240 "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" Appendix 2)

### Specific Responses - Management override of controls

**Irrespective** of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform the following **three** audit procedures to:

① *Evaluate the **business rationale** of those significant and **unusual transactions***

The following are the indicators of unusual transactions: [HKSA 240.A48]

- Over complex transactions (e.g. between multiple entities within a consolidated group or multiple unrelated third parties;
- No discussion of such transactions with those charged with governance and no documentation on those transactions;
- More emphasis on the accounting treatment rather than the underlying economic needs;
- No proper review or approval by those charged with governance on the transactions with non-consolidated related parties
- Transactions with previously unidentified related parties or parties with substantial financial support from the client

② ***Journal entries testing*** [HKSA 240.A41-A44]

<b>Nature</b>	<p>To determine which account balances or classes of transactions journal entries to test, it is necessary to consider the following:</p> <ul style="list-style-type: none"> <li>- Accounts which contain higher risks of material misstatement;</li> <li>- Accounts that have deviations / ineffective controls;</li> <li>- Accounts that have complex/unusual transactions;</li> <li>- Accounts not reconciled on timely basis;</li> <li>- Accounts containing inter-company transactions;</li> <li>- Entries made to unrelated, unusual or seldom-used accounts (e.g. suspense account);</li> <li>- Made by individuals which typically do not make journal entries (e.g. Chief Executive Officer);</li> <li>- Record near the period end with no clear narrative;</li> <li>- Containing round numbers or consistent ending numbers (e.g. 999);</li> <li>- Non-standard journal entries (e.g. consolidation JE)</li> </ul>
<b>Timing</b>	<ul style="list-style-type: none"> <li>- <b>Must</b> test for the journal entries made near period end</li> <li>- Optional to test for the journal entries throughout the period</li> </ul>
<b>Extent</b>	<ul style="list-style-type: none"> <li>- No practical guidance from HKSA 240, depending on the professional judgment</li> </ul>

③ ***Review accounting estimates for biases***

Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, for example, understating or overstating all provisions or reserves in the same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability [HKSA 240.A45 (extracted)].

Therefore, an auditor can perform a **retrospective review** of management judgments and assumptions related to significant accounting estimates reflected in the financial statements of the prior year to determine whether there is an indication of a possible bias on the part of management [HKSA 540.A46 (extracted)].



## February 2010 Section A

### **CASE**

Hong Kong Bauhinia Development Company Limited is a company listed on the Stock Exchange of Hong Kong Limited (“the Stock Exchange”).

Hong Kong Bauhinia Development Company Limited and its subsidiaries (“HKB”) are principally engaged in property investment, management and development. Through decades of development, HKB has created one of Hong Kong’s best known commercial districts in North Bay, which is home to the regional offices of many well-known multinational corporations such as ABC Group, famous retail chain shops such as MBC Retail Chain, and a collection of food, beverage and entertainment outlets with unique themes such as Brazil Coffee Cafe. HKB is the largest commercial landlord in North Bay and has a well-balanced portfolio of superior investment properties. HKB has a quality client base with prominent multinational and strong local tenants, and does not unduly depend on any particular type of tenant.

HKB’s Corporate Governance Guidelines provide for separate roles for the Chairman and Chief Executive Officer. Mr. Raymond Lee serves as the Chairman and Mr. Samuel Ho serves as the Chief Executive Officer. HKB also meets other requirements of the Code Provisions contained in the Code on Corporate Governance Practices set out in Appendix 14 of the Rules Governing the Listing of Securities on the Stock Exchange (“Listing Rules”).

To HKB, good corporate governance is not just an exercise in compliance with the Listing Rules. In its quest to deliver long-term sustainable value to its shareholders, HKB understands the context in which the company operates and makes decisions that balance the needs of various stakeholders. To HKB’s shareholders, this is translated into a commitment to maintaining the highest standards of corporate governance. The cornerstones of HKB’s corporate governance practices are accountability, transparency, and integrity.

HKB has a strong tradition of good corporate governance and a corporate culture based on good business ethics and accountability. HKB has a formal Code of Ethics that is communicated to all staff, all of whom are expected to comply with the code all the time. HKB has also established a “whistle-blowing” system aiming at preventing and detecting fraud or suspected fraud. The “whistle-blowing” system is administered by an independent third party service provider which can directly report to the Chairman of the Audit Committee. HKB aims to build risk awareness and control responsibility into its culture and regards this as the foundation of its internal controls system.

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As Chairman, on various occasions, Mr. Lee has stated clearly that HKB aims to be a financially successful as well as responsible business. He is very proud of HKB being able to contribute to society through its normal business activities, including the areas of environment and health and safety, and by active participation in community activities. For example, HKB has been a strong supporter of the Hong Kong Government's Wastewi\$e Scheme since its inception, and requests all HKB contractors to use eco-friendly cleaning equipment and products within HKB's portfolio of buildings.

In the fourth quarter of 2008, the emergence of the global financial tsunami led to volatility in most financial markets and a contraction in the supply of credit. In Hong Kong, worsened economic conditions decreased the demand for leased commercial properties and intensified competition among landlords. In response, HKB has been adopting prudent financial policies such as making advance arrangements for debts to be re-financed in 2011 and further strengthening its financial and treasury management, budgeting planning and costs control systems.

On initial recognition, HKB measures its investment properties at cost. Subsequent to initial recognition, HKB measures its investment properties at their fair values using the fair value model. HKB derecognises an investment property upon disposal or when the investment property is permanently withdrawn from use or no future economic benefits are expected from its disposals.

HKB did not have any active development projects during the years ended 31 March 2010 and 2009. As at 31 March 2010, all of HKB's investment properties were located in Hong Kong. The turnover and income of HKB are principally derived from the leasing of investment properties located in Hong Kong. Despite worsened economic conditions in Hong Kong in early 2009, HKB still maintains a sustainable income with high occupancy consistently achieved (close to 100% even for the year ended 31 March 2010) and the average lease term is much longer than its competitors. Revenue is measured at the fair value of the consideration received or receivable. Rental income is recognised on a straight-line basis over the term of the relevant lease.

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HKB's consolidated balance sheets at 31 March 2010 and 2009 are as follows:

(HK\$'000)	2010 (unaudited)	2009 (audited)
Investment properties	35,500,241	35,437,223
Property, plant and equipment	76,100	71,327
Prepaid lease payments	134,000	134,000
Investment in associates	1,613,258	1,112,255
Available-for-sale investments	1,077,304	2,489,429
Other financial assets	15,309	14,391
<b>Non-current Assets</b>	<b>38,416,212</b>	<b>39,258,625</b>
Accounts receivable and other receivables	85,880	64,600
Amount due from an associate	30,120	30,120
Other financial assets	35,000	20,850
Cash and cash equivalents	1,072,204	528,516
<b>Current Assets</b>	<b>1,223,204</b>	<b>644,086</b>
<b>Total Assets</b>	<b>39,639,416</b>	<b>39,902,711</b>

(HK\$'000)	2010 (unaudited)	2009 (audited)
Share capital	5,120,200	5,053,187
Reserves	25,810,300	26,750,206
Minority interests	1,141,002	1,090,581
<b>Total Equity</b>	<b>32,071,502</b>	<b>32,893,974</b>
Accounts payable and accruals	330,800	290,322
Rental deposits from tenants	160,606	132,000
Taxation payable	360,500	280,266
<b>Current Liabilities</b>	<b>851,906</b>	<b>702,588</b>
Borrowings	3,100,244	2,322,292
Other financial liabilities	40,508	18,290
Rental deposits from tenants	220,020	205,000
Deferred taxation	3,355,236	3,760,567
<b>Non-current Liabilities</b>	<b>6,716,008</b>	<b>6,306,149</b>
<b>Total Liabilities</b>	<b>7,567,914</b>	<b>7,008,737</b>
<b>Total Equity and Liabilities</b>	<b>39,639,416</b>	<b>39,902,711</b>

HKB's consolidated income statements for the year ended 31 March 2010 and 2009 are as follows:

(HK\$'000)	2010 (unaudited)	2009 (audited)
Turnover	1,790,453	1,498,287
Property expenses	(237,196)	(229,286)
Gross profit	1,553,257	1,269,001
Investment income	60,122	95,066
Other gains and losses	150,898	300,425
Administrative expenses	(140,600)	(105,524)
Finance costs	(150,942)	(176,200)
Change in fair value of investment properties	(220,200)	3,222,352
Share of results of associates	595,000	440,426
Profit before taxation	1,847,535	5,045,546
Income tax expense	(1,300)	(772,967)
<b>Profit for the year</b>	<b>1,846,235</b>	<b>4,272,579</b>
Attributable to:		
Equity holders of HKB	1,712,979	3,888,047
Minority interests	133,256	384,532
	<b>1,846,235</b>	<b>4,272,579</b>

**Question 2** (25 marks – approximately 45 minutes)

Assume that ABC has been re-appointed as HKB's external auditor for 2010 after it reported on HKB's financial statements for the year ended 31 March 2009.

**Required:**

**With respect to the audit of HKB's financial statements for the year ended 31 March 2010:**

- (b) design further audit procedures to examine the **valuation and allocation assertion** of investment properties as at 31 March 2010.

(12 marks)

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**Part (b)**

	<b>Valuation and allocation</b>	<b>Modified answers</b>	
1	Vouch additions to investment properties with supporting documents by checking the sale and purchase agreements and title deeds.	Vouch additions to investment properties with supporting documents by checking the sale and purchase agreements and title deeds.	1
2	Where investment properties have been constructed by the client, check cost records for labour and materials, and where applicable, interest and ensure that they are still classified as investment properties throughout the construction period.	Where investment properties have been constructed by <b>[HKB]</b> , check cost records for labour and materials, and where applicable, interest and ensure that they are still classified as investment properties throughout the construction period.	1
3	Where replacements have been purchased, confirm that the items replaced are removed from the accounting records together with accumulated depreciation (if any).	Where replacements have been purchased, confirm that the items replaced are removed from the accounting records together with accumulated depreciation (if any).	1
4	If client is using fair value model to measure the investment properties:  - Ensure that the entity measures all investment properties at fair value;  - Obtain copies of valuation(s);  - Assess the basis of valuation used;  - Assess the suitability of the valuer(s).	If client is using fair value model to measure the investment properties:  - HKSA 500 "Audit Evidence" or HKSA 620 "Using the Work of an Auditor's Expert"  - Ensure that <b>[HKB]</b> measures all investment properties at fair value;  - Obtain copies of valuation <b>[of investment properties]</b> ;  - Assess the basis of valuation used <b>[in the valuation report, including the assumptions and the data used]</b>  - Assess the <b>competency, objectivity and independence of the valuer such as reviewing the professional qualification of the valuer</b> .	1 1 1 1 1
5	If valuations have been obtained in the period, but not adopted for accounting purposes, ascertain why and compare with the carrying value of the assets.	If valuations have been obtained in the period, but not adopted for accounting purposes, ascertain why and compare with the carrying value of the assets.	1
6	Check that the insured value of fixed assets is not less than the relevant carrying values, and that insurance premiums have been paid up to date.	Check that the insured value of fixed assets is not less than the relevant carrying values, and that insurance premiums have been paid up to date.	1

**Answer 2(b)**

After initial recognition, an entity that chooses the fair value model, such as HKB in this case, shall measure all of its investment properties in accordance with the requirements of HKAS 40 *Investment Property* for that model.

Under the fair value model, the overall audit objective of ABC in examining the valuation and allocation assertion of investment property is to satisfy that items of investment property are stated at an appropriate amount and any resulting valuation adjustments are appropriately recorded.

The measurement of fair value may be relatively simple for certain assets or liabilities that are bought and sold in active and open markets. In other situations, such as the case of investment properties, management of HKB normally has to rely on the expert (professional valuer) to estimate the fair values.

HKSA 620 "Using the work of an expert" requires ABC to assess the professional competence and objectivity of the expert when planning to use the work of an expert. In this case, ABC should ensure that the professional valuer is an independent valuer who holds a recognized and relevant professional qualification (e.g., a member of the Royal Institute of Chartered Surveyors ("RICS")) and has recent experience in the valuation of similar properties in Hong Kong.



HKSA 620 also requires ABC to assess the scope and appropriateness of the professional valuer's work as audit evidence based on:

- (a) ABC's understanding of the methods and significant assumptions used by the expert in determining the fair value of investment properties, and
- (b) ABC's consideration as to whether these assumptions and methods are appropriate, complete and reasonable.

Audit procedures to verify the carrying amount of the investment property as at 31 March 2010 may include:

- Examine the accounting policies for investment property. Determine whether the carrying amount of investment property at the balance sheet date comply with HKB's accounting policies and HKAS 40.
- Obtain a reconciliation between the carrying amounts of the investment property between 1 April 2009 and 31 March 2010, showing items such as additions, disposals and transfer of investment properties, and net change in fair value.
- Agree the balance of investment property as at 1 April 2009 to last year's audited accounts.
- Review or re-perform the calculations of carrying amount as at 31 March 2010, including the examination of the supporting documents for:
  - (a) additions of investment properties resulting from acquisitions and from subsequent expenditure recognised after initial recognition during the period;
  - (b) disposals of investment properties by sale or by entering into finance lease during the period;
  - (c) derecognition of investment properties;
  - (d) transfers of investment properties to and from inventories, owner-occupied property, and property, plant and equipment during the period;
  - (e) net gains or losses arising from changes in the fair value of investment properties during the period; and
  - (f) other movements involving net exchange difference and other changes as per HKAS 40.

Examiners' report

Question 2(b) – 12 marks

This question required candidates to design further audit procedures to examine the valuation and allocation assertion of investment properties as at year end.

Candidates' overall performance was poor. Many candidates failed to understand that, in the case of investment properties, management of HKB normally had to rely on the expert (professional valuer) to estimate the fair values. Many candidates did not make good use of the case information on the accounting treatment of investment properties using the fair value model to answer the question.



**February 2008 Section A**

**CASE**

Hong Kong Printing Company Limited is a company incorporated under the Hong Kong Companies Ordinance and listed on the Hong Kong Stock Exchange.

Hong Kong Printing Company Limited and its subsidiaries ("HKP") are principally engaged in the manufacture and printing of multi-colour packing products, boxes, books, brochures and other paper products. All HKP's production facilities are located in Mainland China.

2007 was a very difficult year for HKP. HKP reported a loss, for the first time since its incorporation 30 years ago, of HK\$23 million. The loss was caused by a drop in sales due to intense market competition, coinciding with increases in variable costs in raw materials and wages.

HKP's operating results in the last five years are as follows:

	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>HK\$'000</b>	<b>HK\$'000</b>	<b>HK\$'000</b>	<b>HK\$'000</b>	<b>HK\$'000</b>
Revenue	423,044	471,222	435,421	451,420	425,345
Operating profit/(loss)	(5,371)	14,312	32,265	28,759	24,487
Finance costs	(8,889)	(7,975)	(10,521)	(10,879)	(12,038)
Profit/(loss) after tax	(23,151)	3,973	16,999	11,118	8,355

Because of the unexpectedly poor operating results, HKP experienced extremely severe operating cash flow problems during the year. HKP delayed paying interest to its major banks in accordance with the loan agreements. As a result of these breaches of covenants, the bank loans became repayable immediately. HKP's management obtained informal understandings from the relevant account managers of the banks that in view of the long term relationship with HKP the banks would not require HKP to repay the loans immediately. However, no formal confirmation of these waivers had been obtained from the banks. The management of HKP was not aware of the financial reporting requirement to reclassify such loans as current when they prepared the draft financial statements for the year ended 31 December 2007.

The draft consolidated balance sheet of HKP as at 31 December 2007 is as follows:

	2007	2006
	HK\$'000	HK\$'000
Pre-paid land lease premium	30,695	31,202
Property, plant and equipment	409,339	350,359
<b>Non-current Assets</b>	440,034	381,561
Inventories	78,788	106,259
Trade and other receivables	85,555	104,443
Bank balances and cash	33,918	48,060
<b>Current Assets</b>	198,261	258,762
<b>Total Assets</b>	<u>638,295</u>	<u>640,323</u>
Share capital	22,255	22,255
Reserves	221,579	244,730
<b>Equity</b>	243,834	266,985
Long-term bank loans	234,120	231,734
Deferred tax liabilities	19,170	20,653
Other non-current liabilities	901	1,210
<b>Non-current Liabilities</b>	254,191	253,597
Taxation payable	1,219	1,827
Current portions of long term bank loans	25,278	23,956
Bills payable	49,516	37,772
Trade and other payables	64,257	56,186
<b>Current Liabilities</b>	140,270	119,741
<b>Total Equity and Liabilities</b>	<u>638,295</u>	<u>640,323</u>

You are a manager at XYZ & Co., HKP's auditor since its incorporation. You have been the manager-in-charge of audits of HKP's financial statements for the last 5 years.

**Question 3 (10 marks - approximately 18 minutes)**

In auditing HKP's financial statements for the last year, you have assessed the risk of material misstatement of all the assertions of HKP's trade and other payables as low, with the expectation that HKP's controls over trade and other payables are operating effectively and have performed tests of controls to confirm your expectation.

**Required:**

**Regarding the completeness of trade and other payables of HKP's financial statements for the current year:**

- (a) **assess the risk of material misstatement at the assertion level; and** (3 marks)
- (b) **determine the most efficient audit approach** and briefly describe the further audit procedures your team would perform in response to the assessed risk.

**[For the purpose of this part, you should determine the audit approach, discuss the timing of the further audit procedures and give not more than three examples**

**Question 3(a)**

Name	Reason
Completeness of trade and other payables	- The risk of material misstatement relating to the completeness of HKP's trade and other payables is <b>low</b> since <b>[the risk of material misstatement of all the assertions of HKP's trade and other payables is low]</b> and there are no other information in the case suggesting that the inherent risk regarding these assertions is high.
	- <b>[There is expectation that HKP's controls over trade and other payables are operating effectively and XYZ &amp; Co. has performed tests of controls to confirm the expectation]</b> therefore the <b>control risk</b> of all the assertions of trade and other payables is <b>low</b> .

3

**Question 3(b)**

① *The most efficient approach*

- ☉ XYZ & Co. should adopt **control-reliance approach** regarding the completeness assertion of trade and other payables since **[there is expectation that HKP's controls over trade and other payables are operating effectively and XYZ & Co. has performed tests of controls to confirm the expectation]**. 1

② *The timing of the further audit procedures*

Timing of tests of controls

- ☉ XYZ & Co. should test the controls specific to completeness assertion of trade and other payables **throughout the year** and it can **consider to rely on the results of tests of controls of the previous audits** as audit evidence of current audits, given that there are no significant system or personnel changes since last testing and the risk of material misstatement is assessed to be low. 1

Timing of substantive procedures

- ☉ XYZ & Co. should perform substantive procedures at year end, given that **and the risk of material misstatement is assessed to be low.** 1

③ Further audit procedures

	<b>Completeness</b>	<b>Modified answers</b>	
1	<p>Select a sample of trade creditor balances and reconcile to supplier statements, to include:</p> <p>Major suppliers, (irrespective of balance at period end);</p> <p>Major balances;</p> <p>Nil balances;</p> <p>Other balances selected on a random or haphazard basis.</p>	<p>Select a sample of trade creditor balances and reconcile to supplier statements, to include:</p> <p>Major suppliers, (irrespective of balance at period end);</p> <p>Major balances;</p> <p>Nil balances;</p> <p>Other balances selected on a random or haphazard basis.</p>	1
2	<p>Undertake a trade creditor circularisation, to include:</p> <p>Major suppliers (irrespective of balance at period end);</p> <p>Major balances;</p> <p>Nil balances;</p> <p>Other balances selected on a random or haphazard basis.</p>	<p>Undertake a trade creditor circularisation, to include:</p> <p>Major suppliers (irrespective of balance at period end);</p> <p>Major balances;</p> <p>Nil balances;</p> <p>Other balances selected on a random or haphazard basis.</p>	1
3	<p>Review prior period list of trade creditors for potentially significant omissions in the current period.</p>	<p>Review prior period list of trade creditors for potentially significant omissions in the current period.</p>	1



**Answer 3(a)**

Completeness of trade and other payables refers to the assertion that all liabilities in trade and other payables that should have been recorded have been recorded.

Under usual circumstances, the inherent risks of material misstatement in completeness (i.e. understating) of trade and other payables would be assessed as normal/medium and the auditor may expect the entity's internal controls to reduce the combined (inherent risk and control risk) risk of material misstatement to low.

Although HKP had experienced severe cash flow problems during the year ended 31 December 2007, there is no indication that the risk of material misstatement in completeness of trade and other payables is particularly high.



Therefore, unless the engagement team suspects fraudulent reporting, which is not apparent from the information given, the engagement team may continue to assess the risk of material misstatement of all the assertions of HKP's trade and other payables as low, with the expectation that HKP's controls over trade and other payables are operating effectively.

[Candidates may draw other conclusions, provided that they can justify them.]

### **Question 3(b)**

Given that tests of controls have been performed in the last year and that there is no material difference in the assessed level of risk of misstatement, it would be most efficient for the engagement team to adopt a combined approach for the completeness of trade and other payables in this case.

The engagement team may use audit evidence about the operating effectiveness of the controls over the completeness of trade and other payables XYZ & Co obtained in last year's audit.

In this case, the engagement team should ask the management of HKP whether there have been any changes in the controls.

The engagement team should observe the operation of the controls or inspect documentary evidence to confirm the understanding of any such changes or absence of changes.

The engagement team should perform tests of control on those changes during the year.

For those controls that have not changed during the year, the engagement team may significantly reduce the extent of tests of controls since satisfactory tests of controls were performed in the previous year's audit.

Substantive procedures to perform in the current year may include:

- (1) substantive analytical procedures, such as comparing inventory turnover and/or the aging of trade payables with standard credit terms granted by suppliers/creditor turnover;
- (2) asking the management to notify any changes in major suppliers and inspecting documentary evidence for management's representations/consistency with records;
- (3) re-calculating the casting of trade and other payables to ensure all ledger balances of trade and other creditors have been included;
- (4) re-performing reconciliations of suppliers' statement to ledger balances.

Examiners' report

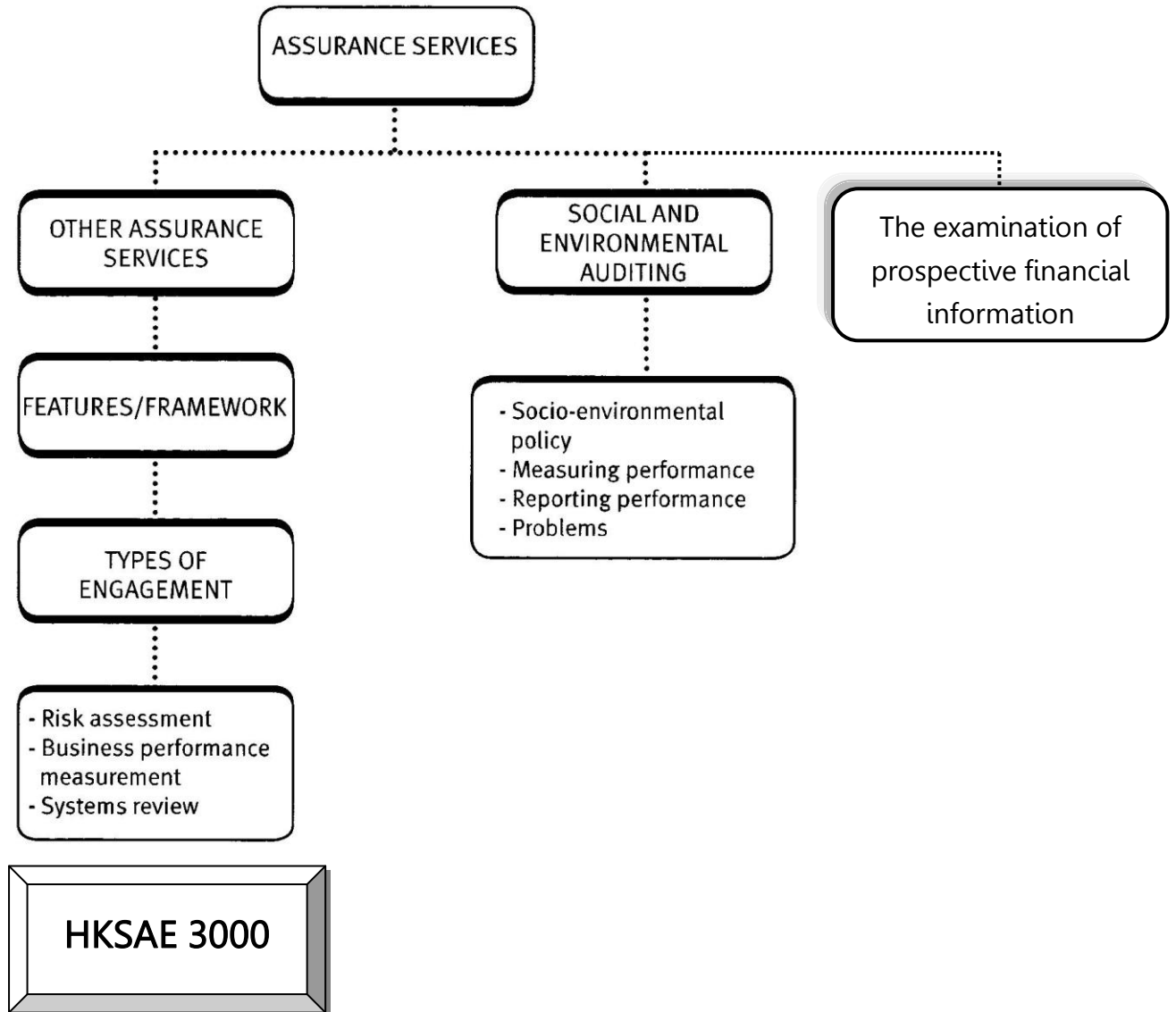
Question 3(a) – 3 marks

The question required candidates to assess the risk of material misstatement of the completeness of trade and other payables. Candidates' performance on this question was average. Many poorly performed candidates assessed the risk as high, without providing any justification, or provided justifications that were not logical, or on the basis of information not given in the case!

Question 3(b) – 7 marks

Similar to Question 2(b), this part required candidates to determine the audit approach and further audit procedures responsive to their assessed risk in Question 3(a). Candidates' performance on this question was average. Similar to Question 2(b), many candidates did not seem to understand the requirements of the question very well and just listed out whatever audit procedures in relation to trade and other payables that came across their mind. However, a higher proportion of candidates appreciated the essence of the question and scored full mark. Those poorly performed candidates simply listed out audit procedures, many of which were irrelevant to the question.

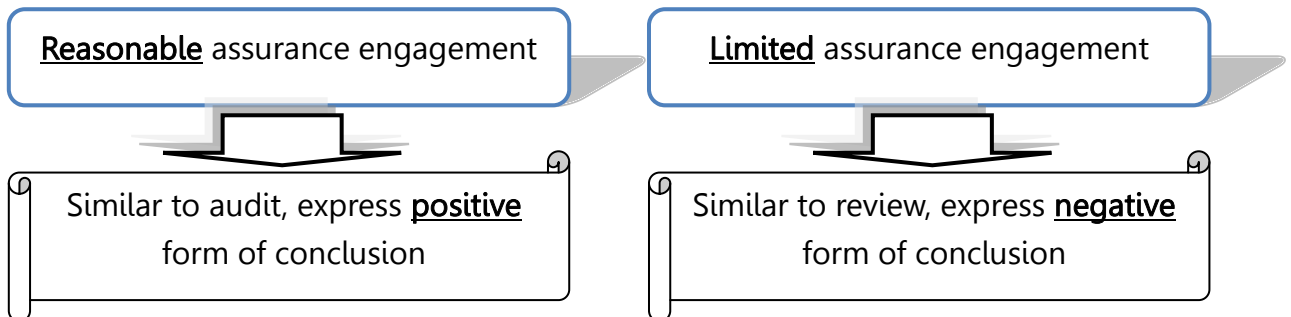
**Audit related services and other assurance engagements**





① **HKSAE 3000 “Assurance Engagements Other Than Audits or Reviews of Historical Financial Information”**

This HKSAE has been written for **general application to assurance engagements other than audits or reviews of historical financial information** covered by HKSAAs or HKSREs, or investment circular reporting engagements covered by HKSIRs. Under this HKSAE, only **two** forms of assurance engagements can be performed [HKSAE 3000.2 (extracted)]:



**The benefits of assurance services**

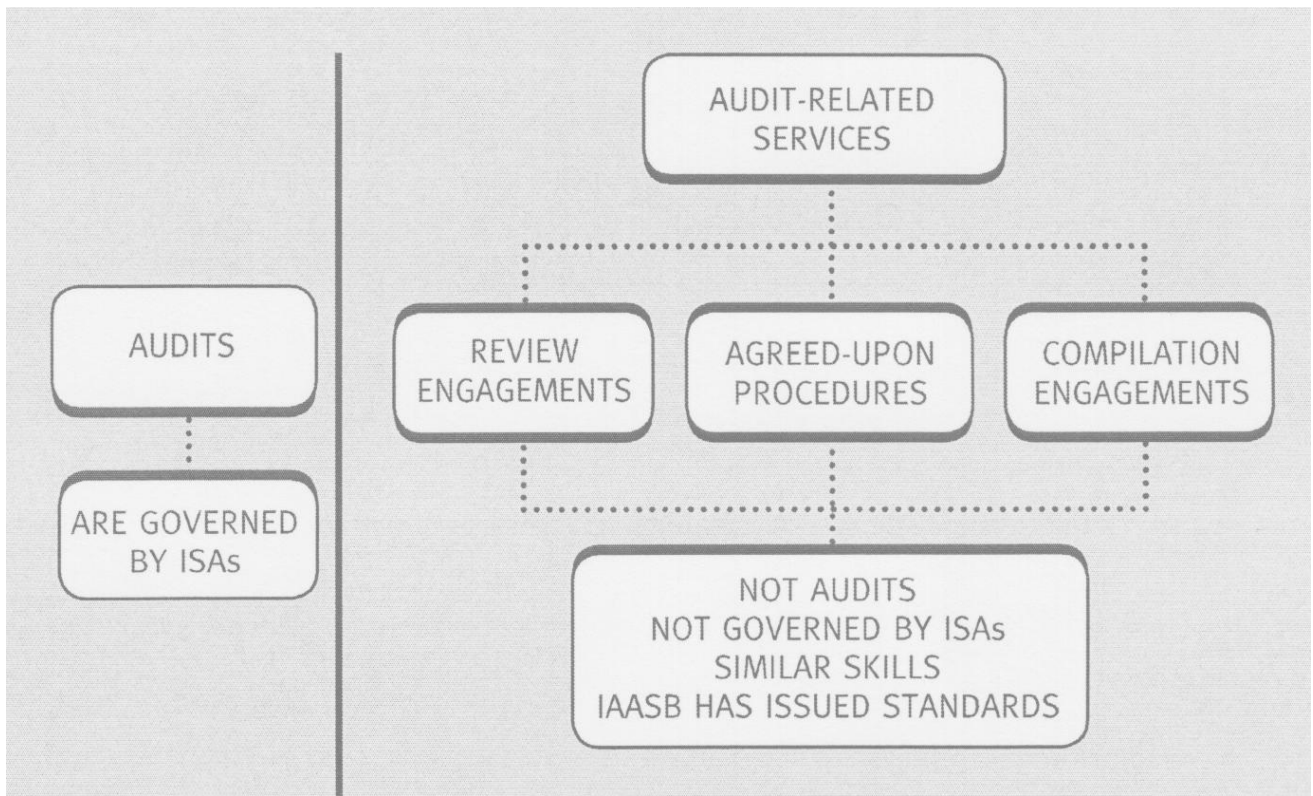
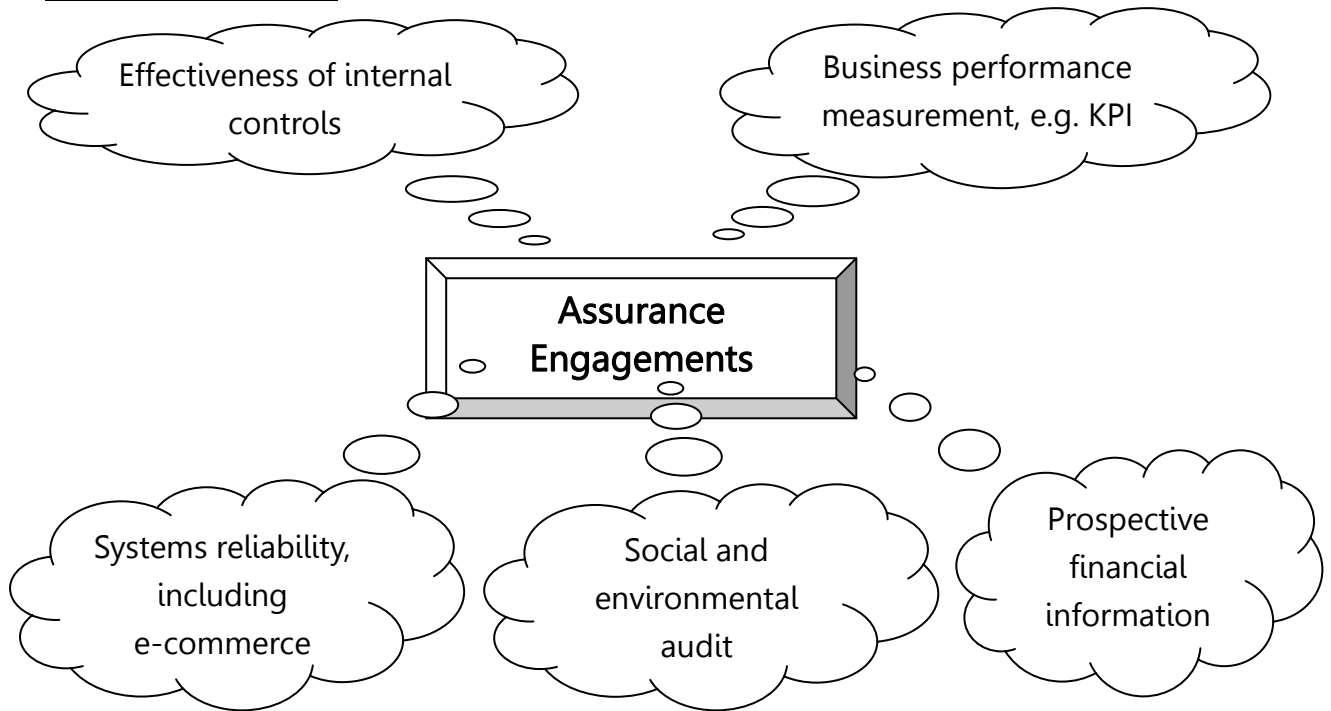
Businesses need to know if their systems are reliable and their business procedures are sound. They may need to demonstrate this to third parties, e.g. a company may wish to persuade influential shareholders that their business plans are sensible and are supported by sound infrastructures. It would be desirable if a third party with the necessary skills and reputation reassured the shareholders.

The assurance services listed above bridge the gap between traditional audit and the problem solving activities of management consultancy. This recognises that decisions are not based on financial information alone, but incorporate a wide range of commercial factors.

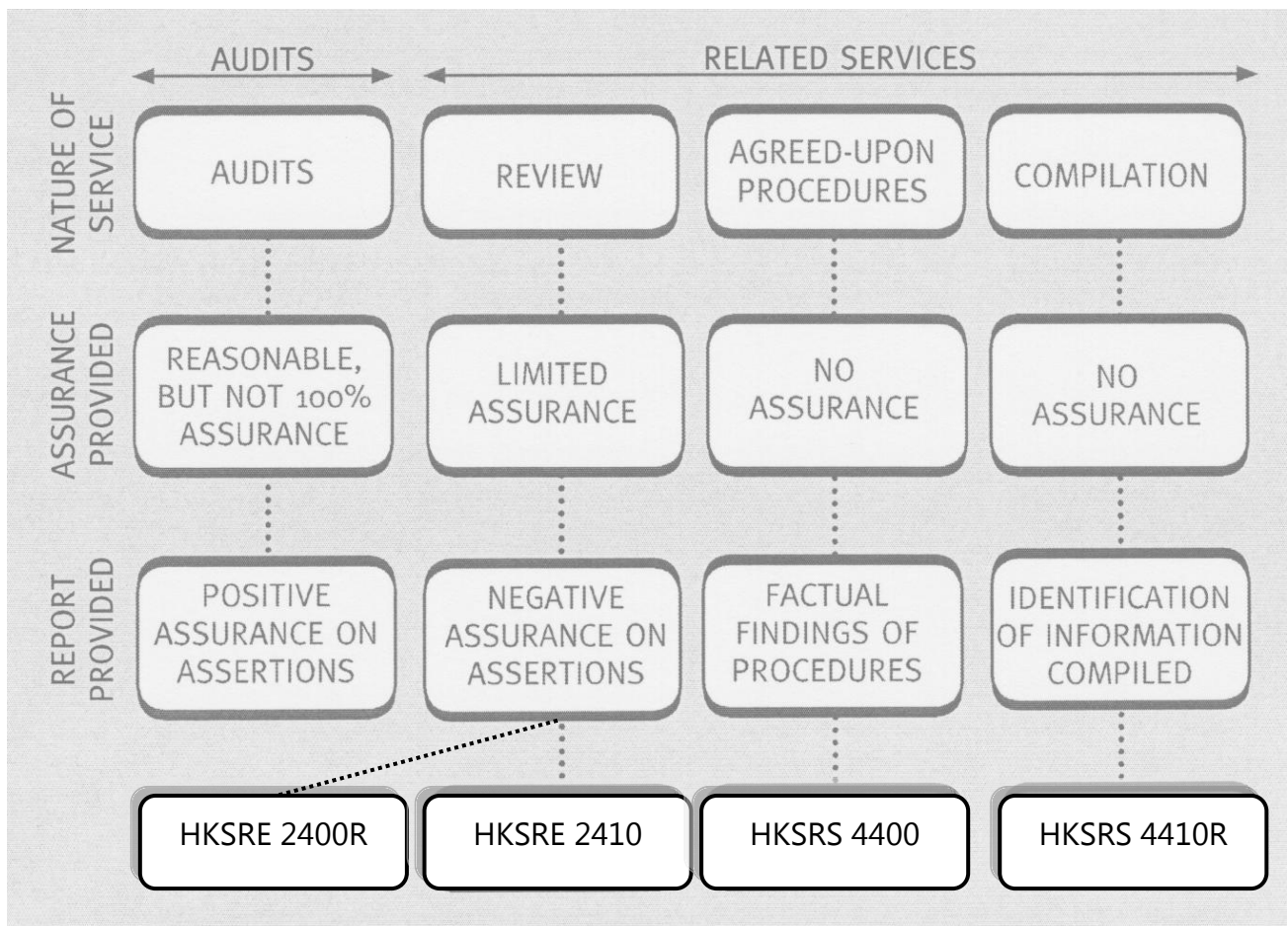
The incumbent auditor is in a strong position to carry out these additional assurance services for their clients. They are professionally trained and already familiar with the business systems in operation at the company. Although this does raise a number of questions regarding the objectivity of the reporting accountant.

In practice, the skills required to offer a comprehensive suite of assurance services mean that it is only the largest firms that can straddle the market to offer a complete range of services to clients. Other firms still offer these services and many specialise in certain areas, such as due diligence.

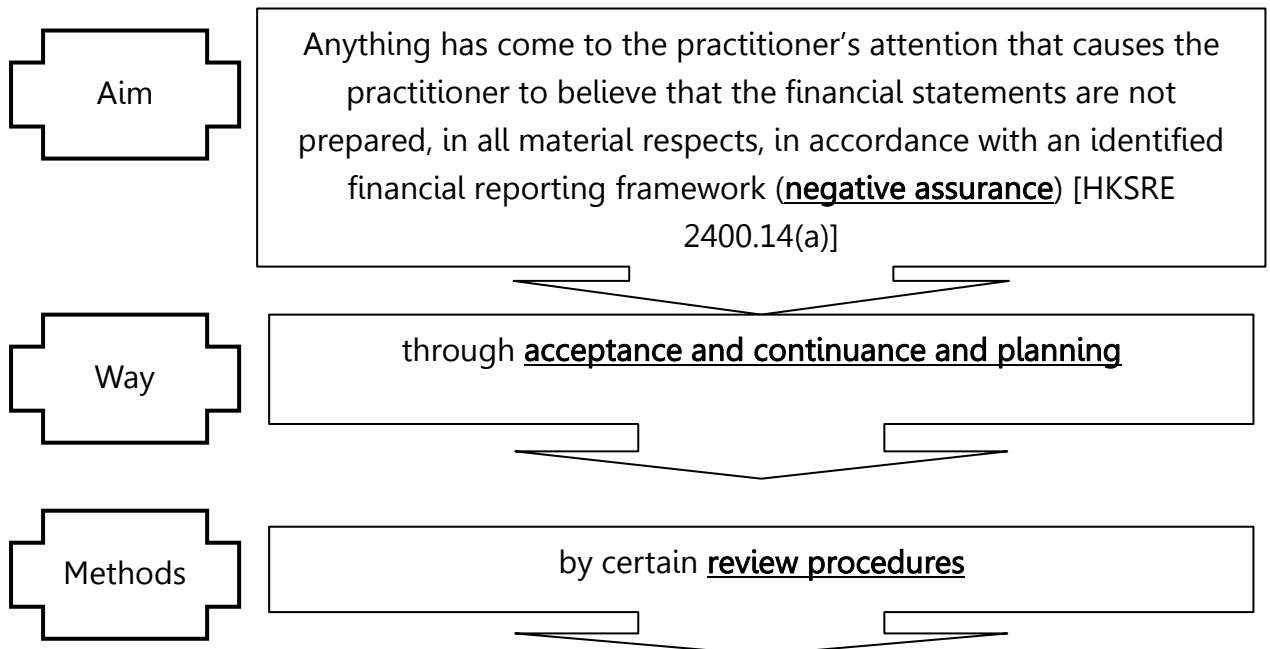
**Main categories of assurance engagements other than audit and review of historical financial information**

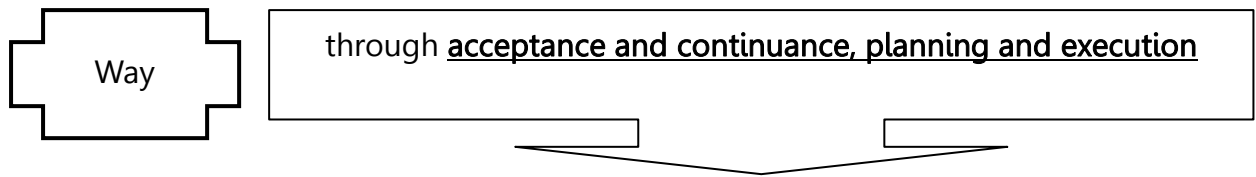




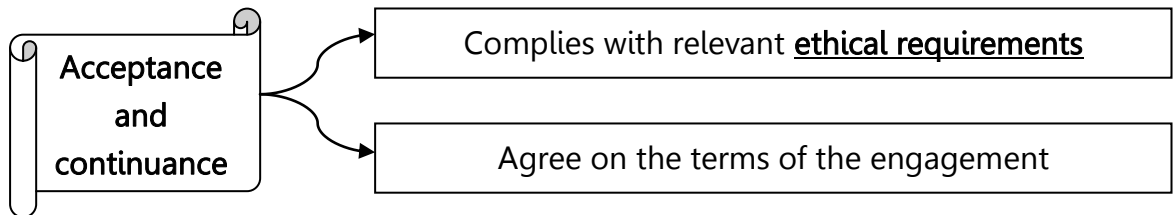


② **HKSRE 2400 (Revised) "Engagements to Review Financial Statements"**





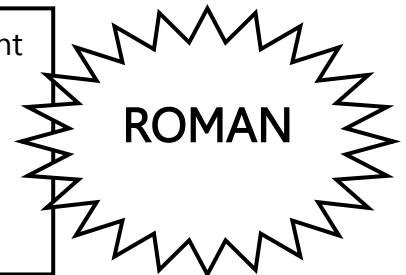
❶ Acceptance and continuance [HKSRE 2400.21, 36-37 (extracted)]



❷ Planning

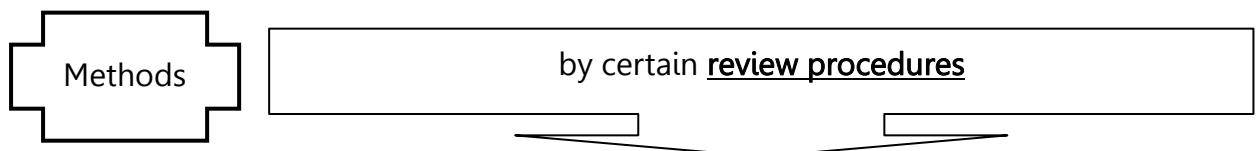
☺ Understanding the entity and its environment [HKSRE 2400.45-46 (extracted)]

- R ⇒ Relevant industry and regulatory environment
- O ⇒ Objectives, strategies and business risks
- M ⇒ Measurement of financial performance
- A ⇒ Accounting policy selection and application
- N ⇒ Nature of the entity



☺ Materiality

The practitioner shall determine materiality for the financial statements as a whole, and apply this materiality in designing the procedures and in evaluating the results obtained from those procedures [HKSRE 2400.43]. The practitioner's judgment about what is material in relation to the financial statements as a whole is the same regardless of the level of assurance obtained by a practitioner as the basis for expressing the conclusion on the financial statements [HKSRE 2400.A73].



In obtaining sufficient appropriate evidence as the basis for a conclusion on the financial statements as a whole, the practitioner shall design and perform inquiry and analytical procedures:

- (a) to address all material items in the financial statements, including disclosures; and
- (b) to focus on addressing areas in the financial statements where material misstatements are likely to arise. [HKSRE 2400.47]

## **Illustrative Detailed Procedures That May be Performed in an Engagement to Review Financial Statements**

1. The inquiry and analytical review procedures carried out in a review of financial statements are determined by the practitioner's judgment. The procedures listed below are for illustrative purposes only. It is not intended that all the procedures suggested apply to every review engagement. This Appendix is not intended to serve as a program or checklist in the conduct of a review.

### **General**

2. Discuss terms and scope of the engagement with the client and the engagement team.
3. Prepare an engagement letter setting forth the terms and scope of the engagement.
4. Obtain an understanding of the entity's business activities and the system for recording financial information and preparing financial statements.
5. Inquire whether all financial information is recorded:
  - (a) Completely;
  - (b) Promptly; and
  - (c) After the necessary authorization.
6. Obtain the trial balance and determine whether it agrees with the general ledger and the financial statements.
7. Consider the results of previous audits and review engagements, including accounting adjustments required.
8. Inquire whether there have been any significant changes in the entity from the previous year (e.g., changes in ownership or changes in capital structure).
9. Inquire about the accounting policies and consider whether:
  - (a) They comply with local or international standards;
  - (b) They have been applied appropriately; and
  - (c) They have been applied consistently and, if not, consider whether disclosure has been made of any changes in the accounting policies.
10. Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.
11. Inquire if actions taken at shareholder, board of directors or comparable meetings that affect the financial statements have been appropriately reflected therein.
12. Inquire about the existence of transactions with related parties, how such transactions have been accounted for and whether related parties have been properly disclosed.
13. Inquire about contingencies and commitments.
14. Inquire about plans to dispose of major assets or business segments.
15. Obtain the financial statements and discuss them with management.
16. Consider the adequacy of disclosure in the financial statements and their suitability as to classification and presentation.
17. Compare the results shown in the current period financial statements with those shown in financial statements for comparable prior periods and, if available, with budgets and forecasts.



18. Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.
19. Consider the effect of any unadjusted errors – individually and in aggregate. Bring the errors to the attention of management and determine how the unadjusted errors will influence the report on the review.
20. Consider obtaining a representation letter from management.

#### **Cash**

21. Obtain the bank reconciliations. Inquire about any old or unusual reconciling items with client personnel.
22. Inquire about transfers between cash accounts for the period before and after the review date.
23. Inquire whether there are any restrictions on cash accounts.

#### **Receivables**

24. Inquire about the accounting policies for initially recording trade receivables and determine whether any allowances are given on such transactions.
25. Obtain a schedule of receivables and determine whether the total agrees with the trial balance.
26. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
27. Obtain an aged analysis of the trade receivables. Inquire about the reason for unusually large accounts, credit balances on accounts or any other unusual balances and inquire about the collectibility of receivables.
28. Discuss with management the classification of receivables, including noncurrent balances, net credit balances and amounts due from shareholders, directors and other related parties in the financial statements.
29. Inquire about the method for identifying “slow payment” accounts and setting allowances for doubtful accounts and consider it for reasonableness.
30. Inquire whether receivables have been pledged, factored or discounted.
31. Inquire about procedures applied to ensure that a proper cutoff of sales transactions and sales returns has been achieved.
32. Inquire whether accounts represent goods shipped on consignment and, if so, whether adjustments have been made to reverse these transactions and include the goods in inventory.
33. Inquire whether any large credits relating to revenue recorded have been issued after the balance sheet date and whether provision has been made for such amounts.

#### **Inventories**

34. Obtain the inventory list and determine whether:
  - (a) The total agrees with the balance in the trial balance; and
  - (b) The list is based on a physical count of inventory.
35. Inquire about the method for counting inventory.
36. Where a physical count was not carried out on the balance sheet date, inquire whether:
  - (a) A perpetual inventory system is used and whether periodic comparisons are made with actual quantities on hand; and
  - (b) An integrated cost system is used and whether it has produced reliable information in the past.

37. Discuss adjustments made resulting from the last physical inventory count.
38. Inquire about procedures applied to control cutoff and any inventory movements.
39. Inquire about the basis used in valuing each category of the inventory and, in particular, regarding the elimination of inter-branch profits. Inquire whether inventory is valued at the lower of cost and net realizable value.
40. Consider the consistency with which inventory valuation methods have been applied, including factors such as material, labour and overhead.
41. Compare amounts of major inventory categories with those of prior periods and with those anticipated for the current period. Inquire about major fluctuations and differences.
42. Compare inventory turnover with that in previous periods.
43. Inquire about the method used for identifying slow moving and obsolete inventory and whether such inventory has been accounted for at net realizable value.
44. Inquire whether any of the inventory has been consigned to the entity and, if so, whether adjustments have been made to exclude such goods from inventory.
45. Inquire whether any inventory is pledged, stored at other locations or on consignment to others and consider whether such transactions have been accounted for appropriately.

**Investments (Including Associated Companies and Marketable Securities)**

46. Obtain a schedule of the investments at the balance sheet date and determine whether it agrees with the trial balance.
47. Inquire about the accounting policy applied to investments.
48. Inquire from management about the carrying values of investments. Consider whether there are any realization problems.
49. Consider whether there has been proper accounting for gains and losses and investment income.
50. Inquire about the classification of long-term and short-term investments.

**Property and Depreciation**

51. Obtain a schedule of the property indicating the cost and accumulated depreciation and determine whether it agrees with the trial balance.
52. Inquire about the accounting policy applied regarding the provision for depreciation and distinguishing between capital and maintenance items. Consider whether the property has suffered a material, permanent impairment in value.
53. Discuss with management the additions and deletions to property accounts and accounting for gains and losses on sales or retirements. Inquire whether all such transactions have been accounted for.
54. Inquire about the consistency with which the depreciation method and rates have been applied and compare depreciation provisions with prior years.
55. Inquire whether there are any liens on the property.
56. Discuss whether lease agreements have been properly reflected in the financial statements in conformity with current accounting pronouncements.

**Prepaid Expenses, Intangibles and Other Assets**

57. Obtain schedules identifying the nature of these accounts and discuss with management the recoverability thereof.
58. Inquire about the basis for recording these accounts and the amortization methods used.



- 59. Compare balances of related expense accounts with those of prior periods and discuss significant variations with management.
- 60. Discuss the classification between long-term and short-term accounts with management.

#### **Loans Payable**

- 61. Obtain from management a schedule of loans payable and determine whether the total agrees with the trial balance.
- 62. Inquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, inquire as to management's actions and whether appropriate adjustments have been made in the financial statements.
- 63. Consider the reasonableness of interest expense in relation to loan balances.
- 64. Inquire whether loans payable are secured.
- 65. Inquire whether loans payable have been classified between noncurrent and current.

#### **Trade Payables**

- 66. Inquire about the accounting policies for initially recording trade payables and whether the entity is entitled to any allowances given on such transactions.
- 67. Obtain and consider explanations of significant variations in account balances from previous periods or from those anticipated.
- 68. Obtain a schedule of trade payables and determine whether the total agrees with the trial balance.
- 69. Inquire whether balances are reconciled with the creditors' statements and compare with prior period balances. Compare turnover with prior periods.
- 70. Consider whether there could be material unrecorded liabilities.
- 71. Inquire whether payables to shareholders, directors and other related parties are separately disclosed.

#### **Accrued and Contingent Liabilities**

- 72. Obtain a schedule of the accrued liabilities and determine whether the total agrees with the trial balance.
- 73. Compare major balances of related expense accounts with similar accounts for prior periods.
- 74. Inquire about approvals for such accruals, terms of payment, compliance with terms, collateral and classification.
- 75. Inquire about the method for determining accrued liabilities.
- 76. Inquire as to the nature of amounts included in contingent liabilities and commitments.
- 77. Inquire whether any actual or contingent liabilities exist which have not been recorded in the accounts. If so, discuss with management whether provisions need to be made in the accounts or whether disclosure should be made in the notes to the financial statements.

#### **Income and Other Taxes**

- 78. Inquire from management if there were any events, including disputes with taxation authorities, which could have a significant effect on the taxes payable by the entity.
- 79. Consider the tax expense in relation to the entity's income for the period.
- 80. Inquire from management as to the adequacy of the recorded deferred and current tax liabilities including provisions in respect of prior periods.

### **Subsequent Events**

81. Obtain from management the latest interim financial statements and compare them with the financial statements being reviewed or with those for comparable periods from the preceding year.
82. Inquire about events after the balance sheet date that would have a material effect on the financial statements under review and, in particular, inquire whether:
  - (a) Any substantial commitments or uncertainties have arisen subsequent to the balance sheet date;
  - (b) Any significant changes in the share capital, long-term debt or working capital have occurred up to the date of inquiry; and
  - (c) Any unusual adjustments have been made during the period between the balance sheet date and the date of inquiry.

Consider the need for adjustments or disclosure in the financial statements.

83. Obtain and read the minutes of meetings of shareholders, directors and appropriate committees subsequent to the balance sheet date.

### **Litigation**

84. Inquire from management whether the entity is the subject of any legal actions-threatened, pending or in process. Consider the effect thereof on the financial statements.

### **Equity**

85. Obtain and consider a schedule of the transactions in the equity accounts, including new issues, retirements and dividends.
86. Inquire whether there are any restrictions on retained earnings or other equity accounts.

### **Operations**

87. Compare results with those of prior periods and those expected for the current period. Discuss significant variations with management.
88. Discuss whether the recognition of major sales and expenses have taken place in the appropriate periods.
89. Consider extraordinary and unusual items.
90. Consider and discuss with management the relationship between related items in the revenue account and assess the reasonableness thereof in the context of similar relationships for prior periods and other information available to the practitioner.

**Other specific procedures in HKSRE 2400:**

① **Related parties**

- ✍ Remain alert for arrangements or information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the practitioner [HKSRE 2400.50]
- ✍ If the practitioner identifies significant transactions outside the entity's normal course of business in the course of performing the review, the practitioner shall **inquire** of management about:
  - (a) The nature of those transactions;
  - (b) Whether related parties could be involved; and
  - (c) The business rationale (or lack thereof) of those transactions [HKSRE 2400.51].

② **Fraud and non-compliance with laws or regulations**

- ✍ Communicate that matter to the appropriate level of senior management or those charged with governance as appropriate;
- ✍ Request management's assessment of the effects, if any, on the financial statements;
- ✍ Consider the effect, if any, of management's assessment of the effects of fraud or non-compliance with laws or regulations communicated to the practitioner on the practitioner's conclusion on the financial statements and on the practitioner's report; and
- ✍ Determine whether there is a responsibility to report the occurrence or suspicion of fraud or illegal acts to a party outside the entity, [HKSRE 2400.52], although the practitioner's professional duty to maintain the confidentiality of client information may preclude such reporting, the practitioner's legal responsibilities may override the duty of confidentiality in some circumstances [HKSRE 2400.A92].

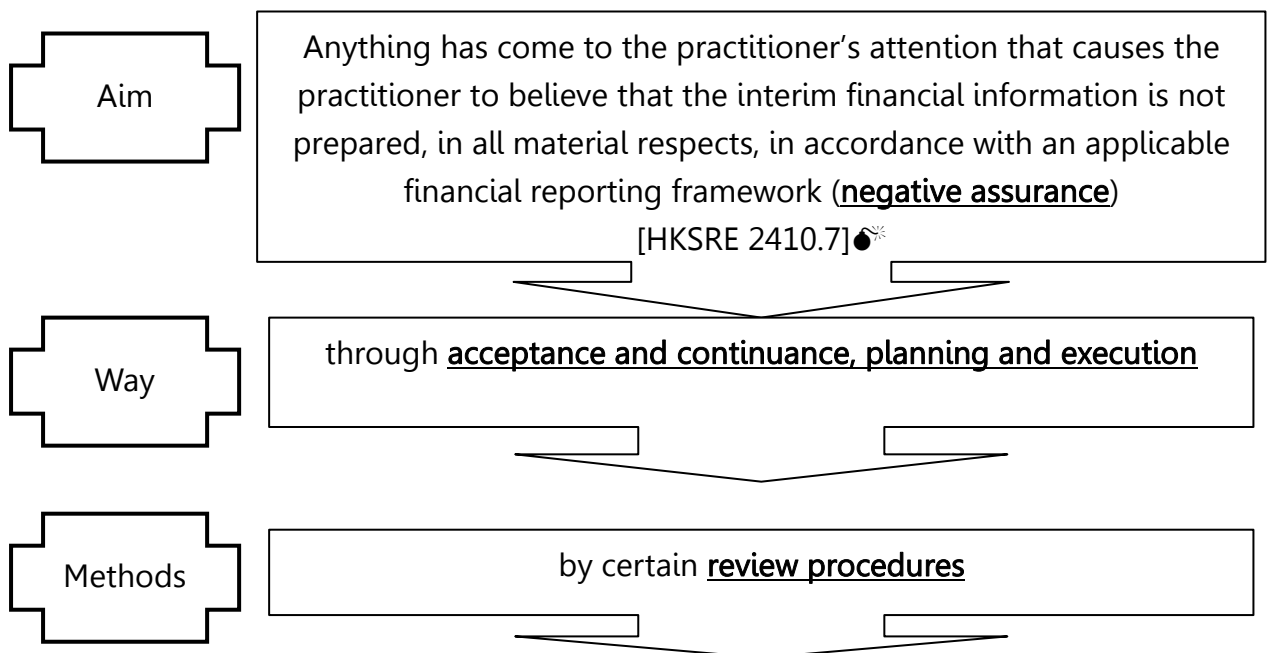
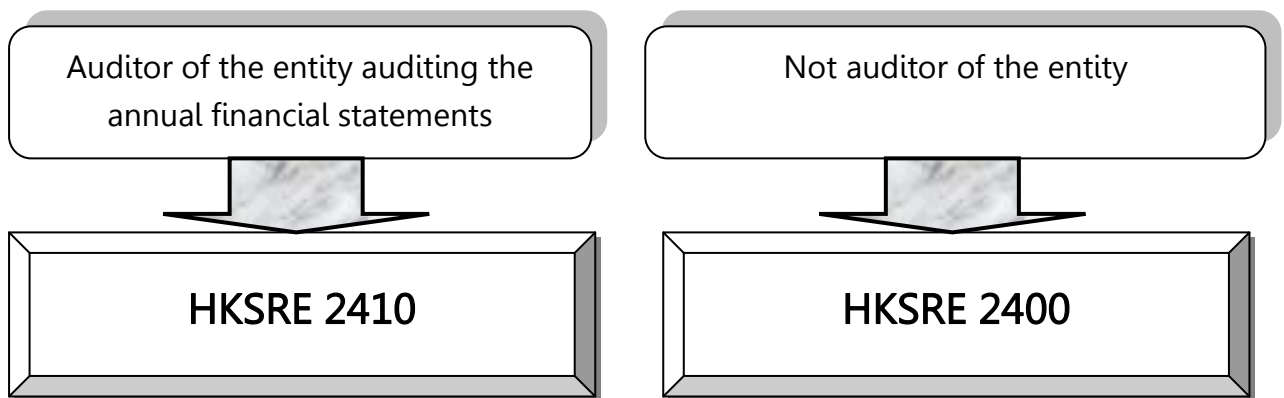
③ Going concern

- ✎ **Inquire** of management about plans for future actions affecting the entity's ability to continue as a going concern and about the feasibility of those plans, and also whether management believes the outcome of those plans will improve the situation regarding the entity's ability to continue as a going concern;
- ✎ Evaluate the results of those inquiries, to consider whether management's responses provide a sufficient basis to:
  - ☺ continue to present the financial statements on the going concern basis if the applicable financial reporting framework includes the assumption of an entity's continuance as a going concern; or
  - ☹ conclude whether the financial statements are materially misstated, or are otherwise misleading regarding the entity's ability to continue as a going concern; and
- ✎ Consider management's responses in light of all relevant information of which the practitioner is aware as a result of the review [HKSRE 2400.54].

③ **HKSRE 2410 “Review of Interim Financial Information Performed by the Independent Auditor of the Entity”**

Through performing the audit of the annual financial statements, the auditor obtains an understanding of the entity and its environment, including its internal control. When the auditor is engaged to review the interim financial information, **this understanding is updated** through inquiries made in the course of the review, and assists the auditor in focusing the inquiries to be made and the analytical and other review procedures to be applied [HKSRE 2410.3 (extracted)].

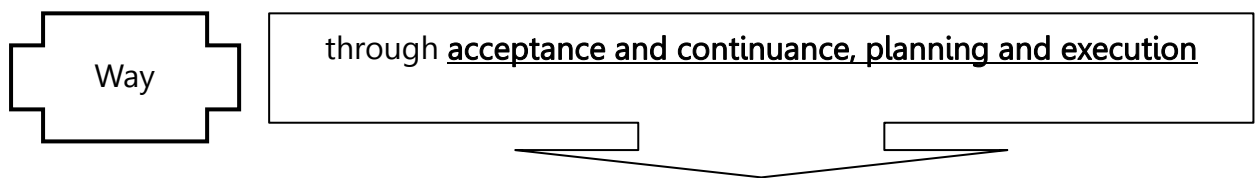
However, if the review of interim financial information is **performed by a practitioner who is not the auditor of the entity**, then: [HKSRE 2410.3 (extracted)]



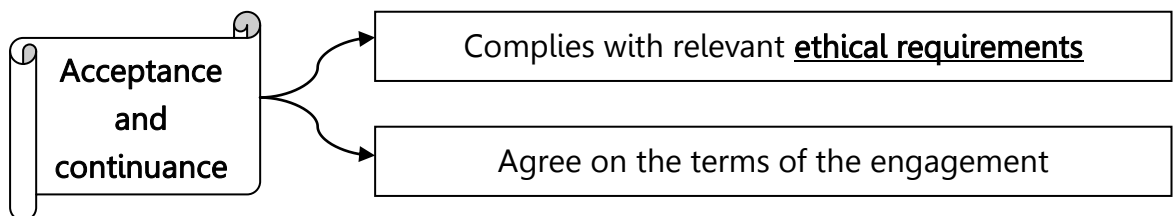


- ☛ A review, in contrast to an audit, is **not designed to obtain reasonable assurance** that the interim financial information is free from material misstatement. A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the interim financial information to the auditor’s attention, but it **does not provide all of the evidence** that would be required in an audit [HKSRE 2410.9].

Therefore, a review ordinarily **does not require tests of the accounting records through inspection, observation or confirmation** which corroborate information obtained concerning significant accounting matters relating to the interim financial information [HKSRE 2410.20 (extracted)].



- ① *Acceptance and continuance* [HKSRE 2410.4, 10 (extracted)]

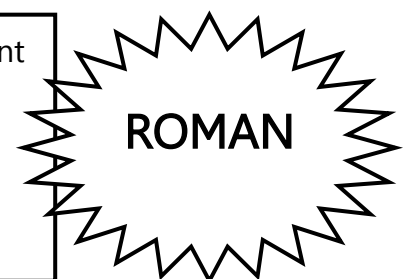


- ② *Planning*

- ☺ Understanding the entity and its environment, including its internal control and fraud consideration [HKSRE 2410.12-14 (extracted)]

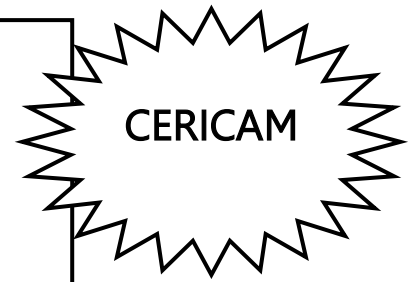
*The Entity and its environment*

- R ⇒ Relevant industry and regulatory environment
- O ⇒ Objectives, strategies and business risks
- M ⇒ Measurement of financial performance
- A ⇒ Accounting policy selection and application
- N ⇒ Nature of the entity



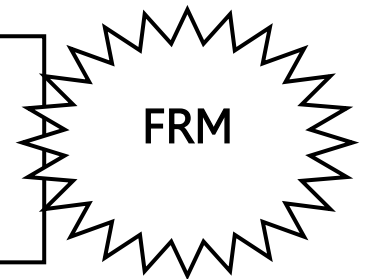
Entity-level internal control

CE ⇒ Control environment  
R ⇒ Risk assessment process  
I ⇒ Information system  
CA ⇒ Control activities relevant to audit  
M ⇒ Monitoring of controls



Fraud consideration

F ⇒ Fraud risk factors evaluation  
R ⇒ Relationship unusualness identified  
M ⇒ Management and those charged with governance



As required by HKSA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment", the auditor who has audited the entity's financial statements for one or more annual periods has obtained an understanding of the entity and its environment, including its internal control, as it relates to the preparation of annual financial information that was sufficient to conduct the audit. In planning a review of interim financial information, the auditor **updates** this understanding [HKSRE 2410.13 (extracted)].

However, for a **recently appointed auditor** who has not yet performed an audit of the annual financial statements in accordance with HKSA's, he should obtain an understanding of the entity and its environment, including its internal control, as it relates to the preparation of **both annual and interim financial information** [HKSRE 2410.17].

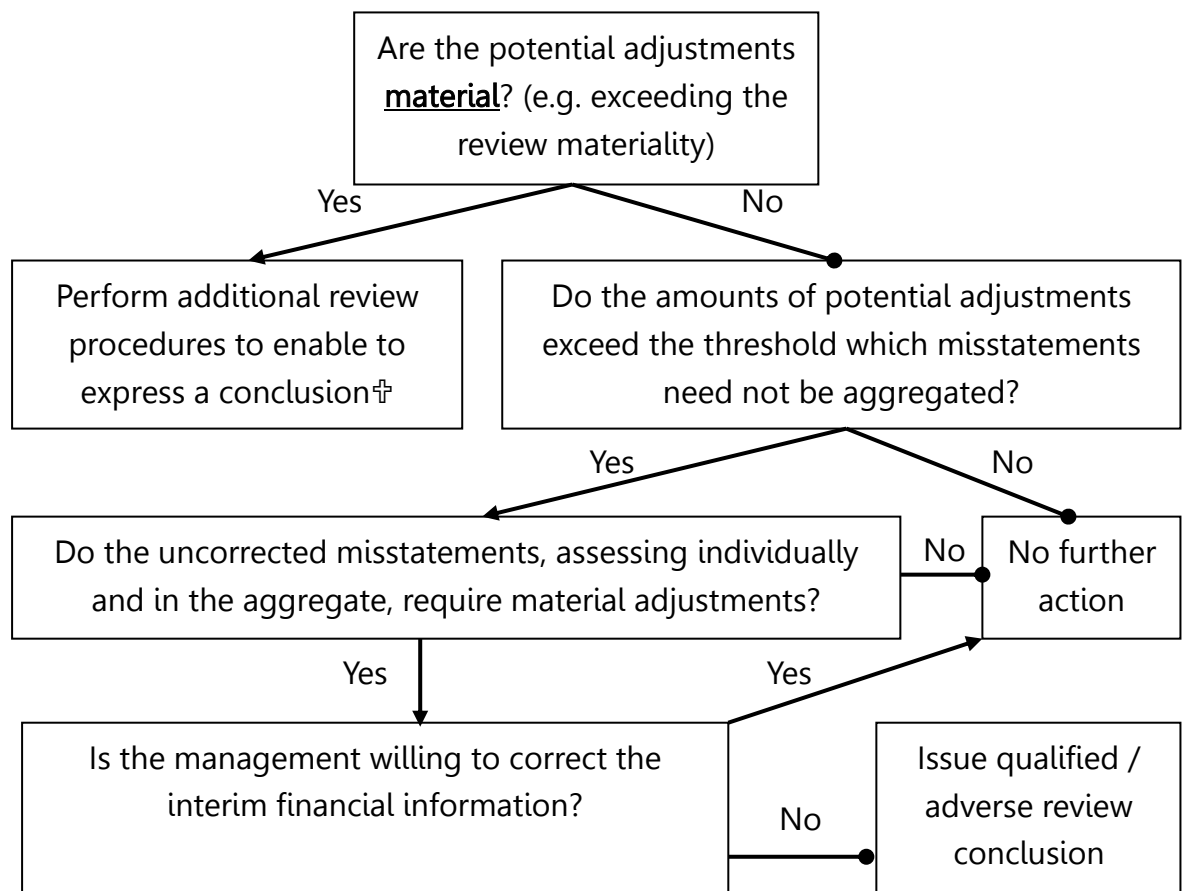
☺ Materiality

Although it is not emphasized in HKSRE 2410, materiality should also be set in order to give the negative assurance that anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all **material respects**, in accordance with an applicable financial reporting framework.

The auditor may designate an amount below which misstatements **need not be aggregated**, because the auditor expects that the aggregation of such amounts clearly would not have a material effect on the interim financial information [HKSRE 2410.33].

③ *Execution*

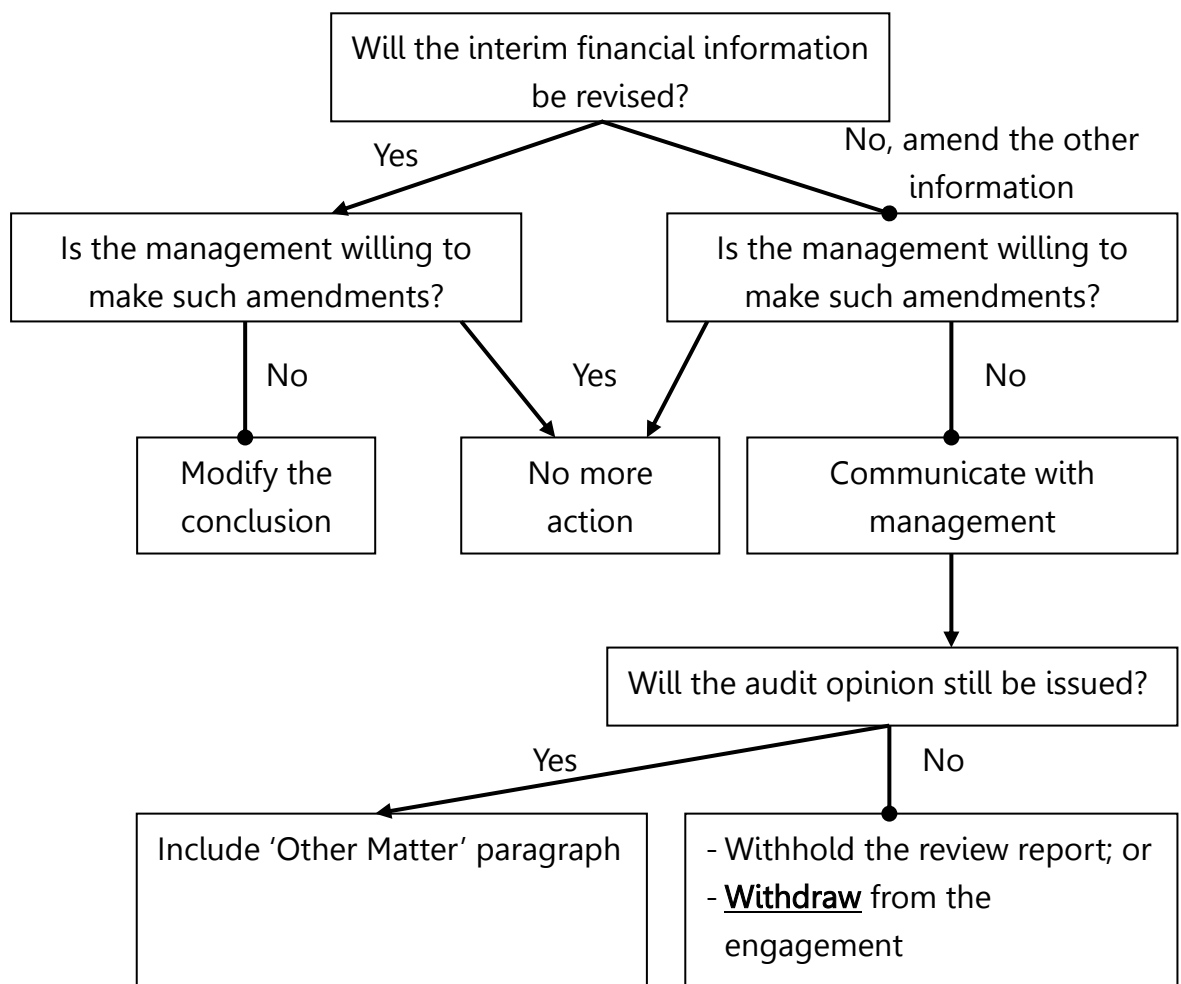
If the auditor discovers **potential adjustments to the interim financial information** during the review, what should he do? [HKSRE 2410.29-32]



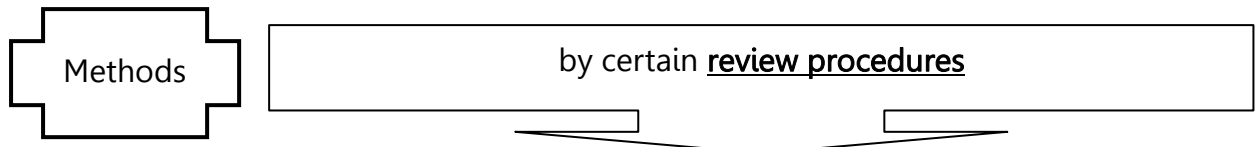
† For example, if the auditor’s review procedures lead the auditor to question whether a significant sales transaction is recorded in accordance with the applicable financial reporting framework, the auditor performs additional procedures sufficient to resolve the auditor’s questions, such as discussing the terms of the transaction with senior marketing and accounting personnel, or reading the sales contract [HKSRE 2410.29 (extracted)].

④ Additional considerations for the auditor’s responsibility relating to other information accompanying the interim financial information [HKSRE 2410.36-37]

The logical flow is the same as **HKSA 720** “The Auditor’s Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements”:



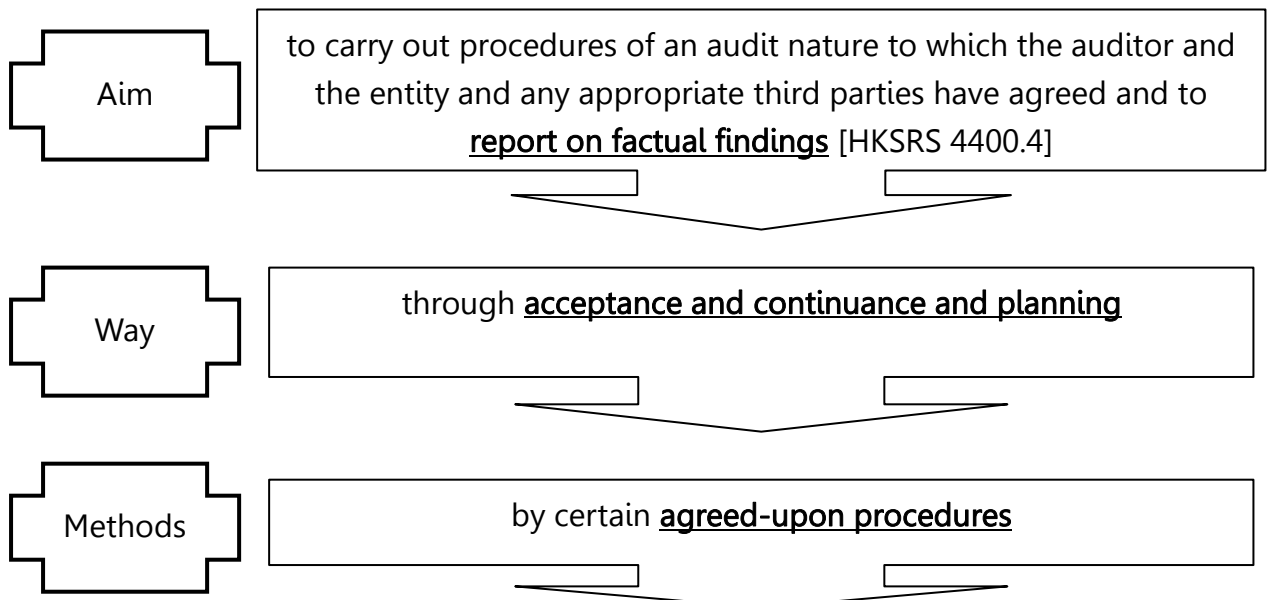


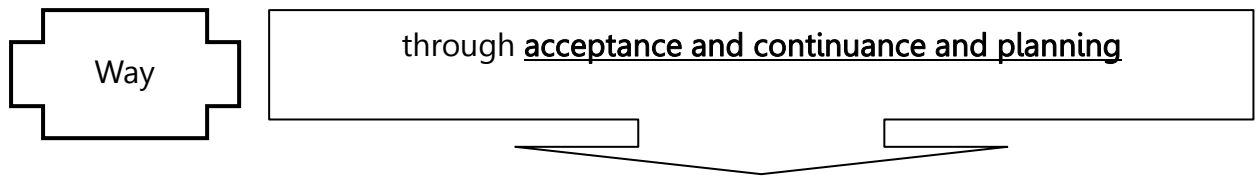


The practitioner should also obtain sufficient appropriate evidence to express the negative assurance report on the interim financial information primarily through inquiry and analytical procedures. The review procedures should follow the detailed steps described in HKSRE 2400 above but change the wordings to 'interim financial information'.

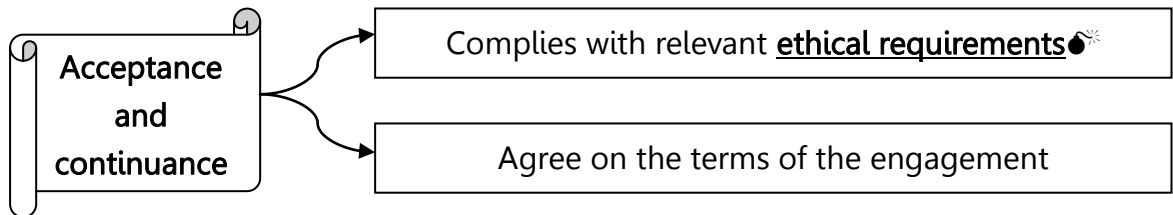
④ **HKSRS 4400 “Engagements to Perform Agreed-Upon Procedures Regarding Financial Information”**

An engagement to perform agreed-upon procedures may involve the auditor in performing certain procedures concerning individual items of financial data (for example, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity), a financial statement (for example, a statement of financial position or even a complete set of financial statements [HKSRS 4400.3]. The most common example in Hong Kong is to perform agreed-upon procedures on the sales of retail companies and to report the factual findings to the landlord to ascertain the amount of turnover rent.





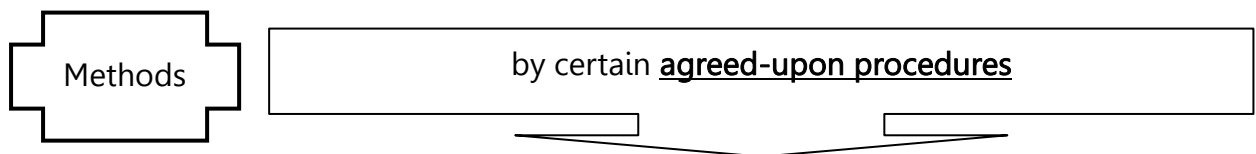
❶ Acceptance and continuance [HKSRS 4400.7, 9 (extracted)]



❶ Independence is not a requirement for agreed-upon procedures engagements; however, the terms or objectives of an engagement may require the auditor to comply with the independence requirements of the *Code of Ethics for Professional Accountants*. Where the auditor is not independent, a statement to that effect would be made in the report of factual findings [HKSRS 4400.7 (extracted)].

❷ Planning

The auditor should plan the work so that an effective engagement will be performed [HKSRS 4400.13]. However, in practice, the planning and execution phases of the agreed-upon procedures will be very near or even at the same time so HKSRS 4400 does not give out any more details in this respect.



- I ⇒ Inquiry ✓
- R ⇒ Recalculation ✓
- AP ⇒ Analytical Procedures
- R ⇒ Reperformance
- O ⇒ Observation ✓
- C ⇒ Confirmation ✓
- I ⇒ Inspection ✓



## Example of a Report of Factual Findings in Connection With Accounts Payable

### REPORT OF FACTUAL FINDINGS

To (those who engaged the auditor)

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of ABC Company as at (date), set forth in the accompanying schedules (not shown in this example). Our engagement was undertaken in accordance with Hong Kong Standard on Related Services 4400, "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" issued by the Hong Kong Institute of Certified Public Accountants (HKICPA). The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarized as follows:

1. We obtained and checked the addition of the trial balance of accounts payable as at (date) prepared by ABC Company, and we compared the total to the balance in the related general ledger account.
2. We compared the attached list (not shown in this example) of major suppliers and the amounts owing at (date) to the related names and amounts in the trial balance.
3. We obtained suppliers' statements or requested suppliers to confirm balances owing at (date).
4. We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding checks, each of which was greater than xxx. We located and examined such invoices and credit notes subsequently received and checks subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

We report our findings below:

- (a) With respect to item 1 we found the addition to be correct and the total amount to be in agreement.
- (b) With respect to item 2 we found the amounts compared to be in agreement.
- (c) With respect to item 3 we found there were suppliers' statements for all such suppliers.
- (d) With respect to item 4 we found the amounts agreed, or with respect to amounts which did not agree, we found ABC Company had prepared reconciliations and that the credit notes, invoices and outstanding checks over xxx were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute an assurance engagement made in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements, we do not express any assurance on the accounts payable as of (date).

Had we performed additional procedures or had we performed an assurance engagement of the financial statements in accordance with Hong Kong Standards on Auditing, Hong Kong Standards on Review Engagements or Hong Kong Standards on Assurance Engagements issued by the HKICPA, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

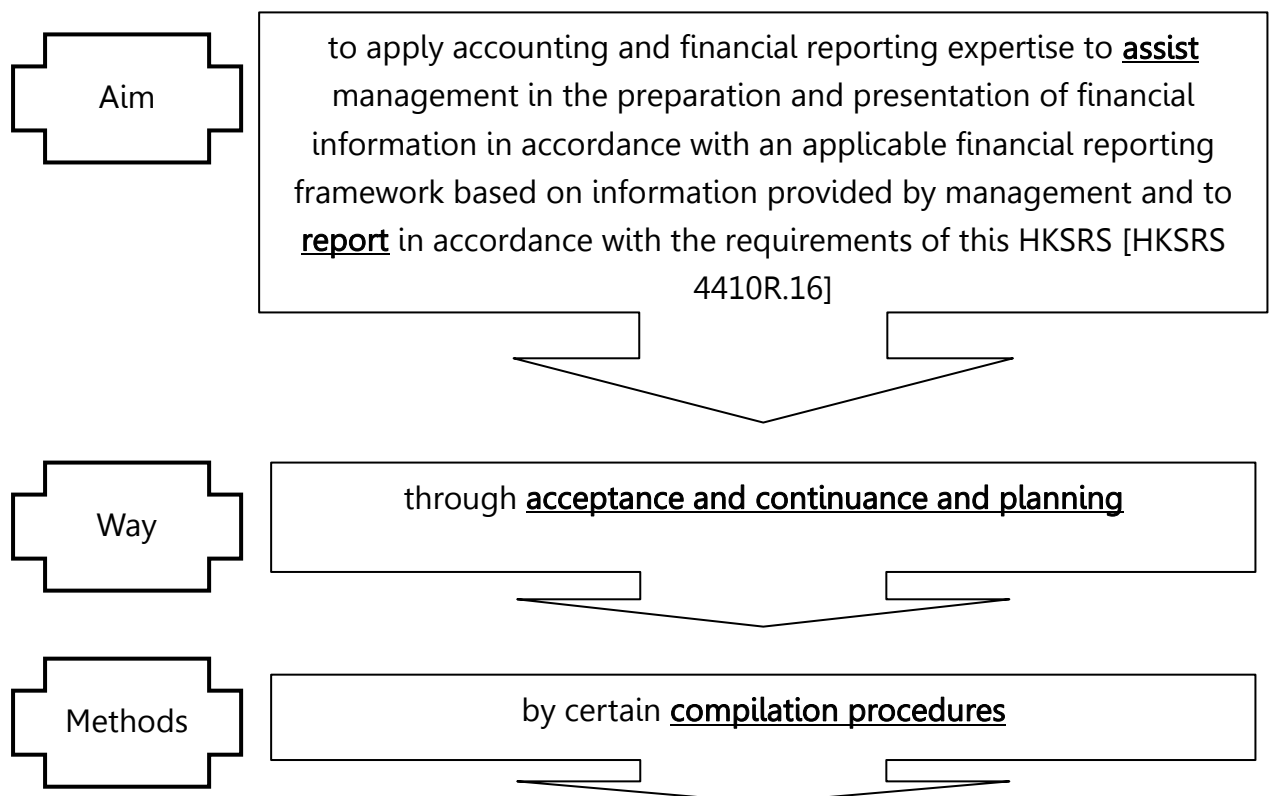
XYZ & Co.  
Certified Public Accountants (Practising) [or Certified Public Accountants]  
Hong Kong  
Date

(Source: HKSRS 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" Appendix 2)

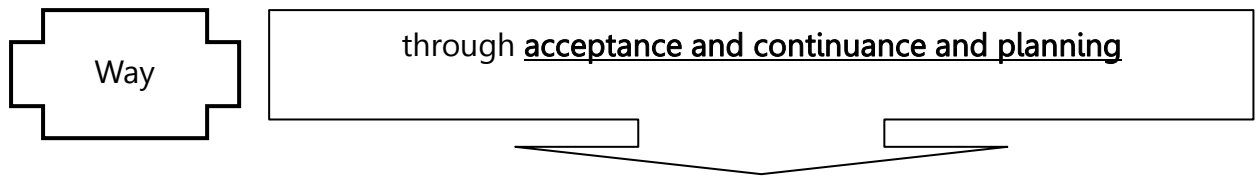
⑤ **HKSRS 4410 (Revised) “Compilation Engagements”**

This HKSRS deals with the practitioner’s responsibilities when engaged to **assist management with the preparation and presentation of historical financial information or other financial information** such as pro forma or prospective financial information [HKSRS 4410R.A3 (extracted)], without obtaining any assurance on that information, and to report on the engagement in accordance with this HKSRS [HKSRS 4410R.1].

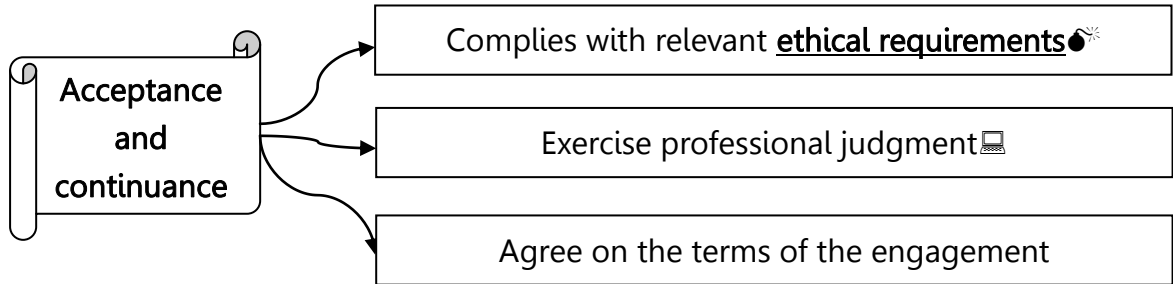
Since a compilation engagement is **not an assurance engagement**, a compilation engagement does not require the practitioner to verify the accuracy or completeness of the information provided by management for the compilation, or otherwise to gather evidence to express an audit opinion or a review conclusion on the preparation of the financial information [HKSRS 4410R.6]. Also, management retains responsibility for the **selection and application of appropriate accounting policies and developing reasonable accounting estimates** [HKSRS 4410R.7 (extracted)].







❶ *Acceptance and continuance* [HKSRS 4400.7, 9 (extracted)]



☛ Section 290 "Independence - Audit and Review Engagements and Section 291 "Independence - Other Assurance Engagements" in Part B of the Code **do not apply** to compilation engagements [HKSRS 4410R.A21 (extracted)].

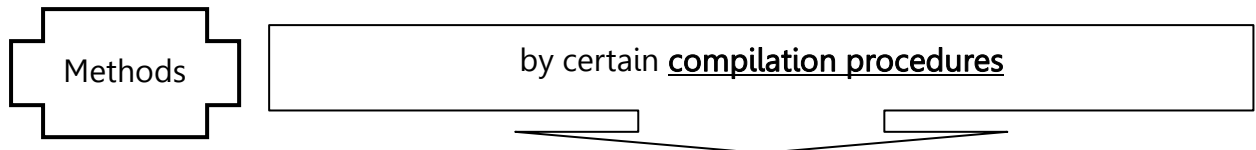
📖 Professional judgment is necessary, in particular, when the engagement involves assisting management of the entity regarding decisions about:

- the acceptability of the financial reporting framework; and
- Selection of appropriate accounting policies under that framework, development of accounting estimates and preparation and presentation of financial information [HKSRS 4410R.A22 (extracted)].

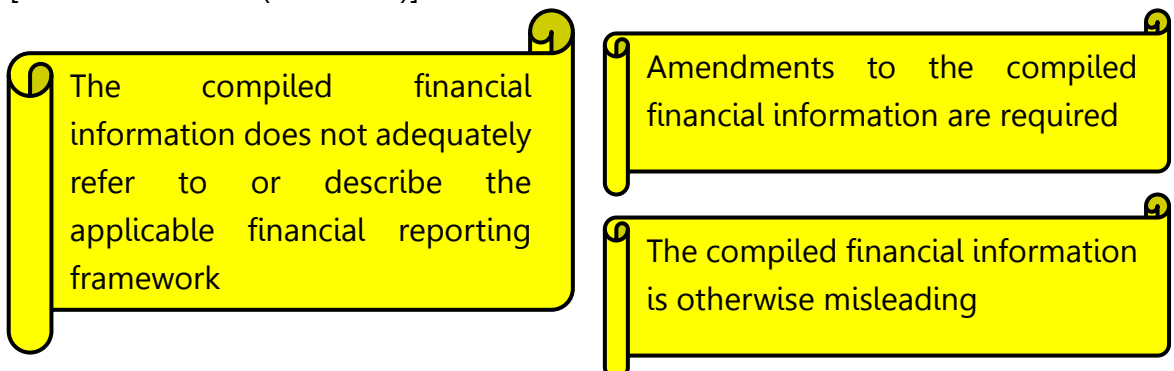
❷ *Planning*

The practitioner shall obtain an understanding of the following matters sufficient to be able to perform the compilation engagement:

- (a) The entity's **business and operations**, including the entity's accounting system and accounting records; and
- (b) The **applicable financial reporting framework**, including its application in the entity's industry [HKSRS 4410R.28].



- ✎ Compile the financial information using the records, documents, explanations and other information, including significant judgments, provided by management;
  - ✎ Discuss with management, or those charged with governance as appropriate, those significant judgments, for which the practitioner has provided assistance in the course of compiling the financial information; and
  - ✎ Read the compiled financial information in light of the practitioner's understanding of the entity's business and operations, and of the applicable financial reporting framework [HKSRS 4410R.29-31 (extracted)].
- ⊖ The practitioner shall **propose the appropriate amendments** to management when [HKSRS 4410R.34 (extracted)]:



**IF** management declines, or does not permit the practitioner to make the proposed amendments to the compiled financial information, the practitioner shall **withdraw** from the engagement and inform management and those charged with governance of the reasons for withdrawing [HKSRS 4410R.35].

**Illustration 1: Practitioner's report for an engagement to compile financial statements using a general purpose financial reporting framework.**

- General purpose financial statements required under applicable law that specifies that the entity's financial statements are to be prepared applying Hong Kong Financial Reporting Standards for Private Entities (HKFRS-PE).

PRACTITIONER'S COMPILATION REPORT

[To Management of ABC Company]

We have compiled the accompanying financial statements of ABC Company based on information you have provided. These financial statements comprise the statement of financial position of ABC Company as at 31 December 20X1, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

We performed this compilation engagement in accordance with Hong Kong Standard on Related Services 4410 (Revised), *Compilation Engagements*.

We have applied our expertise in accounting and financial reporting to assist you in the preparation and presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards for Private Entities (HKFRS-PE). We have complied with relevant ethical requirements, including principles of integrity, objectivity, professional competence and due care.

These financial statements and the accuracy and completeness of the information used to compile them are your responsibility.<sup>6b</sup>

Since a compilation engagement is not an assurance engagement, we are not required to verify the accuracy or completeness of the information you provided to us to compile these financial statements. Accordingly, we do not express an audit opinion or a review conclusion on whether these financial statements are prepared in accordance with HKFRS-PE.

[Practitioner's signature]

[Date of practitioner's report]

[Practitioner's address]

(Source: HKSRS 4410 (Revised) "Compilation Engagements" Appendix 2)