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

Hong Kong's
CPA Qualification
香港會計師專業資格

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

Speaker
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EXECUTIVE TRAINING COMPANY (INTERNATIONAL) LTD

About the Lecturer

Dr Fiona Lam

Managing Director and Principal Lecturer – MC & MD

PhD, FCA(UK), FCCA, FAIA,
CPA(Practising), BBA(Acc & Fin), FTIHK

- **Practising partner of a medium size firm**
- **Practical experience in corporate governance, risk management, auditing and tax**
- **Passed QP exams and other exams ie ACCA, AIA, PC all in one go**
- **Professional training 10 years ago and has been teaching MC & MD since then**
- **Taught over 6000 students**

Module C Business Assurance

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

- Identifying and assessing the risks of material misstatement at assertion level
  (HKSA 315 (Revised))
- Corporate governance
- Written representations from management
  (HKSA 580 (Clarified))

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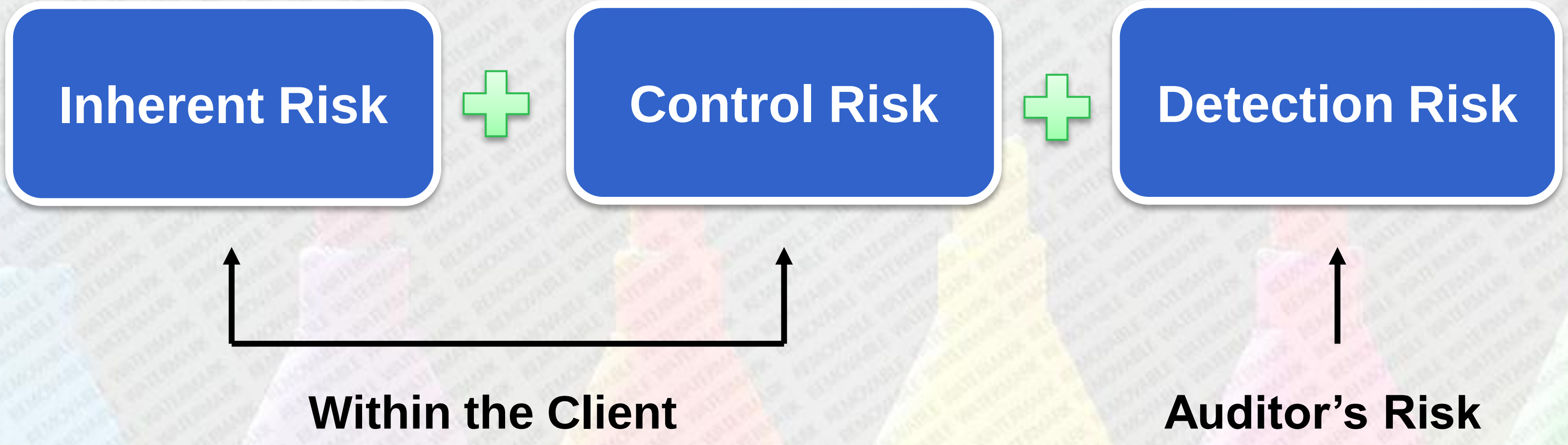
HKSA 315 (Revised)

MC – HKSA 315 (Revised)

Audit Risk – Definition & Components

It is "risk that auditor expresses an **inappropriate audit opinion** when the financial statements are materially misstated taken as a whole"



Inherent Risk ➕ Control Risk ➕ Detection Risk

Within the Client

Auditor's Risk

MC – HKSA 315 (Revised)

Inherent Risk ("IR")

- Refers to the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were **no related internal controls**.

- Example:
- Industry environmental factors – competitiveness
- Technological obsolescence or over-dependence on single product
- Accounts which require expert valuations

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Control Risk ("CR")

- Refers the risk that a misstatement that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, **will not be prevented or detected and corrected** on a timely basis by the accounting and **control systems**.

- **If the company has good internal controls, there is a high chance that the control system will detect a material error.**

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Detection Risk (“DR”)

- Refers risk that the **auditor will not detect a material misstatement** that exists in an assertion where the audit procedures fail in its effectiveness. Auditor should amend his NET (Nature, Extent and Timeliness) of the audit procedures.

- Sampling risk and non-sampling risk are components of detection risk.

- Eg Incoming auditor – ie not familiar with the audit client.

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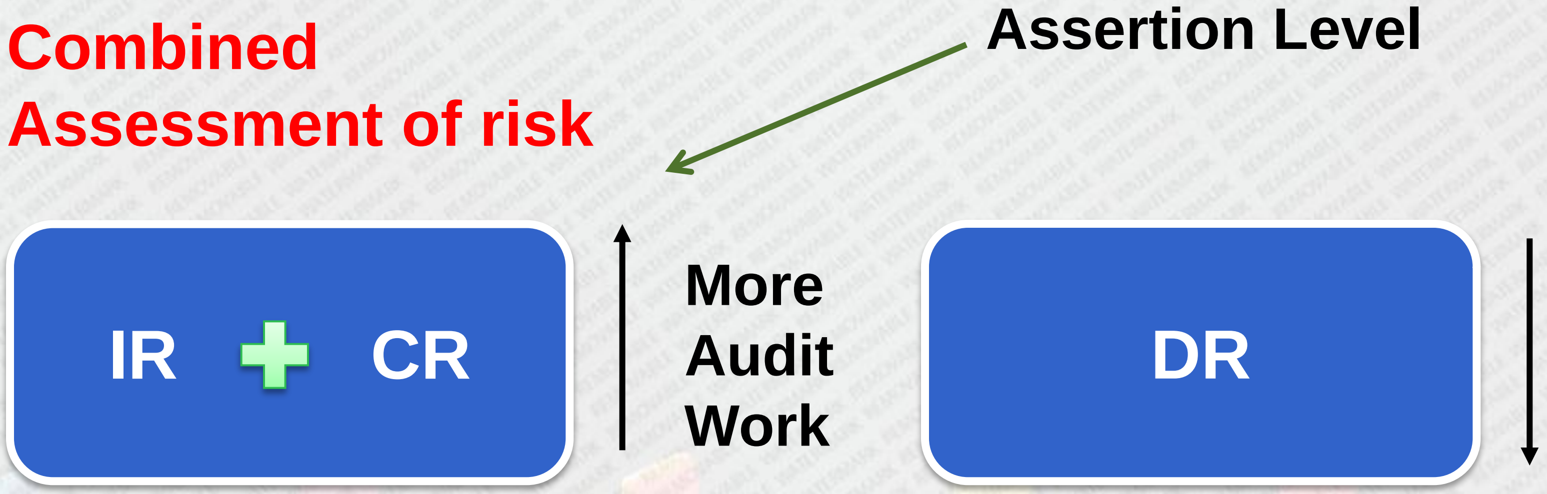
Inverse Relationship



Combined Assessment of risk

Assertion Level

IR ➕ CR

More Audit Work

DR

Perform Risk Assessment only on IR and CR

MC – HKSA 315 (Revised)

HKSA 315 (Revised) Risk Assessment [**NEW]

Why revised the standard? As there are changes in HKSA 610 (Revised) related to internal auditors

Risk Assessment Procedures and Related Activities

a) **Inquiries of management, the internal audit function and others within the entity**

- auditor can obtain information through inquiries with the **internal audit function**, if the entity has such a function

- inquiries directed to **the risk management function**

MC – HKSA 315 (Revised)

HKSA 315 (Revised) Risk Assessment [**NEW]

- inquiries directed to **information systems** personnel may provide information about system changes, system or control failures

b) Inquiries of the internal audit function

- the internal audit function is likely to **have obtained insight into the entity’s operations and business risks**, and may have findings based on its work, such as identified control deficiencies or risks

- internal audit function provides information to the auditor regarding any **actual, suspected or alleged fraud**

MC – HKSA 315 (Revised)

HKSA 315 (Revised) Risk Assessment [**NEW]

c) Considerations specific to public sector entities

Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying **the risk of material non-compliance with applicable laws and regulations** and the **risk of deficiencies in internal control** over financial reporting.

MC – HKSA 315 (Revised)

HKSA 315 (Revised) Risk Assessment [**NEW]

d) Audit evidence for elements of the control environment

The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies

The auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures

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HKSA 315 (Revised) Risk Assessment

Requirement: (Must perform)

1. Identify and Assess the risks of material misstatements **at the (Overall) financial statement level** and at the **assertion level** for classes of transactions(P/L), account balances (B/S) and disclosures.

2. Determine risks that require **special audit consideration** and consider whether the controls are implemented **(“Significant Risks”)**

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HKSA 315 (Revised) Risk Assessment

3. **Evaluate the design of entity's controls** and determine the implementation of the entity's controls

4. If is **not possible** or impracticable to reduce the risks of material misstatements at the assertion level to an acceptably low level with audit evidence obtained by substantive testing, then auditor should evaluate the design and implementation of the client's controls i.e. in a computerized system, lack of paper trail

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Collect Audit Evidence

- Main purpose = to obtain sufficient and appropriate audit evidence to support audit opinion

- Ways to collect audit evidence

  - **Risk Assessment**
  - Tests of Controls
  - Substantive Testing

MC – HKSA 315 (Revised)

Risk of material misstatement at Financial Statement Level – General

- Applying to the financial statement **as a whole**
- Able to reduce audit risk to an **acceptably low level**
- More **pervasive** to the financial statement at a whole
- **Affect many assertions**

MC – HKSA 315 (Revised)

Risk of material misstatement at Financial Statement Level – Factors to consider

*** Always related to management***

- Risks from a weak **control environment** which includes management's attitudes to good internal control practice
- Management's attitude towards a good internal control
- Management's competence, integrity and experience

MC – HKSA 315 (Revised)

Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Unusual pressures** on management (ie plan to go public, bonuses ties to sales or profits)

- Nature of entity's business – risky Industry, market fluctuations

- Industry factors ie **Special regulations and reporting changes** (ie Listing companies, securities companies, insurance companies, banks)

MC – HKSA 315 (Revised)

Risk of material misstatement at Financial Statement Level – Other Factors to consider

- **Aggressive business strategies** – fast expansion, plenty of acquisition and mergers

- Significant business risk
  - ➢ Cannot focus on a specific risk
  - ➢ Concern about the client’s going concern
  - ➢ Concern about fraud

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HKSA 330 (Clarified) Responses to assessed risk – FS Level

- Reduce audit risk to an **acceptability low level**, auditor should determine overall responses to assessed risks of material misstatements at the financial statement level and **documentation is required**

- Consider Control Environment

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HKSA 330 (Clarified) Responses to assessed risk – FS Level

***** Use general audit strategy *****

For Example:

- Assigning more staff or more training for staff
- More supervision for staff
- Emphasizing to audit staff the need to maintain professional skepticism

MC – HKSA 315 (Revised)

HKSA 330 (Clarified) Responses to assessed risk – FS Level

- Collect more persuasive evidence and more procedures
- Using experts
- Incorporating more unpredictability into the audit procedures
- Change nature, extent and timeliness of substantive tests

MC – HKSA 315 (Revised)

HKSA 330 (Clarified) Responses to assessed risk – FS Level

Responses when Risk at FS Level is **Low:**

- No response except to **maintain professional skepticism**
  - Questioning of mind, alert to audit evidence and make effort to support management representations

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HKSA 330 (Clarified) Responses to assessed risk – FS Level

Responses when Risk at FS Level is **Medium**:

- Remind the engagement to maintain professional skepticism
- Assign more experienced staff
- Budget more review and supervision

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HKSA 330 (Clarified) Responses to assessed risk – FS Level

Responses when Risk at FS Level is **High**:

- Remind the engagement to maintain professional skepticism
- Assign more experienced staff
- Budget more review and supervision

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HKSA 330 (Clarified) Responses to assessed risk – FS Level

Add:

- Assign an expert ie computer fraud
- Do not rely on client's internal control and use substantive procedures only
- Perform audit procedures in unexpected manner
- Resigning from engagement

MC – HKSA 315 (Revised)

Significant Risks

- Requires **special audit attention** since they are often related to **significant non-routine transactions and judgement**
- **Non-routine transactions** are unusual and occur infrequently
- Transactions that involve **great deal of management intervention**
- Transactions with great deal of **manual intervention** for data collection and processing

MC – HKSA 315 (Revised)

Significant Risks

- **Complex calculations** involved
- Where it is **difficult to implement** effective controls
- Accounting **estimates** or revenue recognition may be subject to different interpretation
- **Subjective judgement** required for complex transactions and require great deal of assumptions

MC – HKSA 315 (Revised)

Significant Risks

- Transactions involved **fraud**

Responses:

- Must perform test of controls on controls that mitigate significant risks
- Must perform specific substantive testing

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Risk of material misstatement at Assertion Level

- **Not able** to reduce the risks of material misstatement to an acceptably low level with audit evidence obtained only from substantive procedures

- Refer to specific **classes of transactions, accounts balances**

- Risks arise from the particular characteristics of a class of transaction – **inherent and control risk**

- Identify controls that are likely to **prevent, detect or correct** material misstatements

MC – HKSA 315 (Revised)

Risk of material misstatement at Assertion Level – General

- Comprises of IR and CR **(Combined Assessment of the Risk of Material Misstatements)**
- Auditor would perform **tests of controls** to support the risk assessment

MC – HKSA 315 (Revised)

Risk of material misstatement at Assertion Level – Factors to consider

- Accounts likely to be susceptible to misstatements (ie required many adjustments in previous year’s audit or accounts that include estimated amounts)
- **Complexity of underlying transactions** (ie financial instruments)
- Degree of judgement involved in determining account balances (ie provision for contingent liabilities and warranty expenses)
- Susceptibility of assets to loss or misappropriation

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Risk of material misstatement at Assertion Level – Responses

- **Design and perform appropriate audit procedures to address** to the assessed risks of material misstatements at the assertion level and for each material class of transactions, account balances and disclosure.

- Determine risks that require special audit considerations and consider whether the controls are implemented

- Evaluate the design of entity's controls and determine the implementation of the entity's controls vouching etc

- **Documentation of N (Nature) E (Extent) T (Timeliness)** of further audit procedures, linkage of those procedures with

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N – Nature of Substantive Testing

- Consider performing Substantive Testing only or both
- Tests of controls and substantive testing
- Type such as inspection, observation, inquiry etc
- Use **Substantive Approach** – Perform only substantive testing
- Use **Combined Approach** – Use both test of control and substantive testing

MC – HKSA 315 (Revised)

E – Extent of Substantive Testing

- **Quantity** of a specific audit procedures to be performed
- Required judgment
- After consideration of materiality
- Higher Risk = increase extent
- Use sampling approach or not?

MC – HKSA 315 (Revised)

T – Timeliness of Substantive Testing

- Perform further audit procedures **at an interim or at period end**
- Perform audit procedures before the period end – to identify significant matters at early stage of audit
- Higher risk = perform sub tests nearer to or at period end

MC – HKSA 315 (Revised)

Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Existence** – Assets, liabilities, and equity interests do not exist at the Balance Sheet Date

Examples for increase risk:

- Multi-locations
- Assets held by third parties
- Assets that have special characteristics – require an expert to identify

MC – HKSA 315 (Revised)

Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Completeness** – All assets, liabilities and equity interests that should have been recorded have not been recorded.

Examples for increase risk:

- Multi-locations, assets held by third party
- Wrong posting, off balance sheet items
- Understate of liabilities

MC – HKSA 315 (Revised)

Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Valuation and Allocation** – Assets, liabilities, and equity interests are included in the financial statements **at inappropriate amounts** and any resulting valuation or allocation adjustments are not appropriately recorded

Examples for increase risk:

- Valuation subject to heavy estimate / heavy market fluctuations / expert’s valuation / heavy complex calculation is involved in the valuation ie manufactured goods – DM, DL, OH

MC – HKSA 315 (Revised)

Risk of material misstatement at Assertion levels

Statement of Financial Statements – Account Balance – Assertion Risk

- **Rights and Obligations** – The entity does not hold or control the rights to assets, and liabilities are not the obligations of the entity

Examples to increase risk:

- Subsequent events – Title has been passed
- Many different contracts with many different terms
- Title is subject to specific HKAS

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Risk of material misstatement at Assertion levels

Income Statement – Assertion Risk

- **Occurrence** – Transactions and events that have been recorded have not (1) **occurred** nor (2) pertain to the entity.

Example to increase risk:

- Sales occurred at year end
- Multiple sales – Sales last for several years
- Invoice not with the client
- Consignment sales

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Risk of material misstatement at Assertion levels

Income Statement – Assertion Risk

- **Completeness** – All transactions and events that should have been recorded have not been **recorded**

Examples to increase projects:

- Consignment sales
- Cutoff dates different for many companies
- No pre-numbering invoice
- No authorization and sales invoice

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Risk of material misstatement at Assertion levels

Income Statement – Assertion Risk

- **Cutoff** – Transactions and events have been recorded in an **incorrect accounting period**.

Examples to increase risk:

- Transactions taken after year end
- Management’s cutoff procedures not adequate

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Risk of material misstatement at Assertion levels

Income Statement – Assertion Risk

Accuracy / Measurement – Amounts and other data relating to recorded transactions and events have not been **recorded appropriately**.

Examples to increase risk:

- Complex HKAS
- Transactions terms have different interpretations
- Involve overseas accounting standards
- Require expert to interpret

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Exam Questions Review
Dec 2012 – Qu 5a
Risk assessment at assertion level

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Qu 5a (Extracted)

Question

You are working on an audit engagement for a client who owns over 150 chain shoe stores in Hong Kong. Your client owns 5 different shoe brands and each of the brands specializes in a different style of shoe products. During the course of the audit, you look into the inventory ledger and find that the inventory balance as at year end increased three-fold to HK$200 million compared to last year, representing 20% of the total assets of the company as at year end, and the inventory aging has been deteriorating significantly compared to last year.

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Qu 5a (Extracted) (Cont'd)

You therefore discuss with the management their assessment on the appropriateness of the inventory provision. The managing director explains to you that he is very optimistic about their future development. According to the managing director, they have just acquired 3 more shoe brands and will open another 50 shoe stores in Hong Kong in the coming year and therefore the inventory balance as at year end had tripled compared to last year. In addition, he is confident that there will be no inventory provision required against their shoe products given that their shoe products are always well-received by their customers in the market.

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Qu 5a (Extracted) (Cont'd)

Required:

Assess and explain the risk of material misstatement relating to the accounting estimate over the inventory valuation as at year end.

(5 marks)

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Answer 5a (Extracted)

The risk of material misstatement over the inventory valuation is **high**. The increase in risk of material misstatement over the inventory valuation is mainly due to:

- the inventory balance as at year end is **significant** to the company’s total assets (ie 20%). Any material misstatement in the inventory balance could result in pervasive misstatement in the financial statement as a whole.

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Answer 5a (Extracted) (Cont'd)

- **the financial trend does not look reasonable**. The increase in inventory is far more than the company's plan of expansion which indicates that there may be slow-moving inventory piling up.
- the deterioration of inventory aging is supportive that there may be **slow-moving inventory** and management should factor it in the inventory provision assessment.
- management's assessment of inventory provision purely relies on **past trend** without taking into account a totality of facts which may indicate management bias.

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Exam Questions Review Dec 2012 – Qu 6a,b

Risk assessment at assertion level

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Qu 6a,b (Extracted)

In a recent dialogue with the Internal Audit, you understand that the Internal Audit has issued an unsatisfactory report on the bank reconciliation process of your client. The Internal Audit report indicated that there was significant control deficiency over the cash management process, and that the management processes and controls were not properly exercised by the operation team.

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Qu 6a,b (Extracted) (Cont'd)

Required:

a) Assess and explain the risk of material misstatement relating to the existence and accuracy assertions of the cash and bank balance as at year end.

(3 marks)

b) Suggest and explain the audit procedures you would perform in response to the risk of material misstatement identified in Question 6(a).

(7 marks)

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Answer 6a (Extracted)

The risk of material misstatement on cash and bank balances is **high** because of the following:

- the bank reconciliation process does not operate effectively which may increase the risk of unidentified accounting errors and adjustments; and

- there is an increased opportunity for misappropriation of cash given that the management’s processes and controls were not properly exercised by the operation team.

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Answer 6b (Extracted)

The audit team should consider the following audit procedures in response to the risk of material misstatement over cash and bank balances identified in (a):

- review the Internal Audit Report in detail and discuss with Internal Audit findings with management and reassess the risk of material misstatements of cash and bank balance;
- understand from management the remedial action plan and implementation timeline;

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Answer 6b (Extracted) (Cont'd)

- identify whether there are compensating controls and consider performing the testing of the compensating controls by understanding, evaluating and validating the key management compensating controls;

- instead of relying on management's control over cash management, consider a substantive testing approach by performing test of details;

- circulate bank confirmations directly to every bank with which the company conducted business; verify the bank balances with the replies to the standard bank letter;

- check the bank balances against the respective bank statements;

MC – Exam Questions Review

[Risk assessment at assertion level]
Dec 2012 – Answer 6b (Extracted) (Cont'd)

- reperform the bank reconciliation by comparing the cash ledger balance and the balance stated on bank statements/ bank confirmations, obtain an explanation from management for any large or unusual items not cleared at the time of audit;

- obtain satisfactory explanations for all items in the cash book for which there are no corresponding entries in the bank statement and vice versa through discussion with finance staff; and

- check subsequent bank statements to confirm the validity of the bank reconciliation items (eg un-presented cheques).

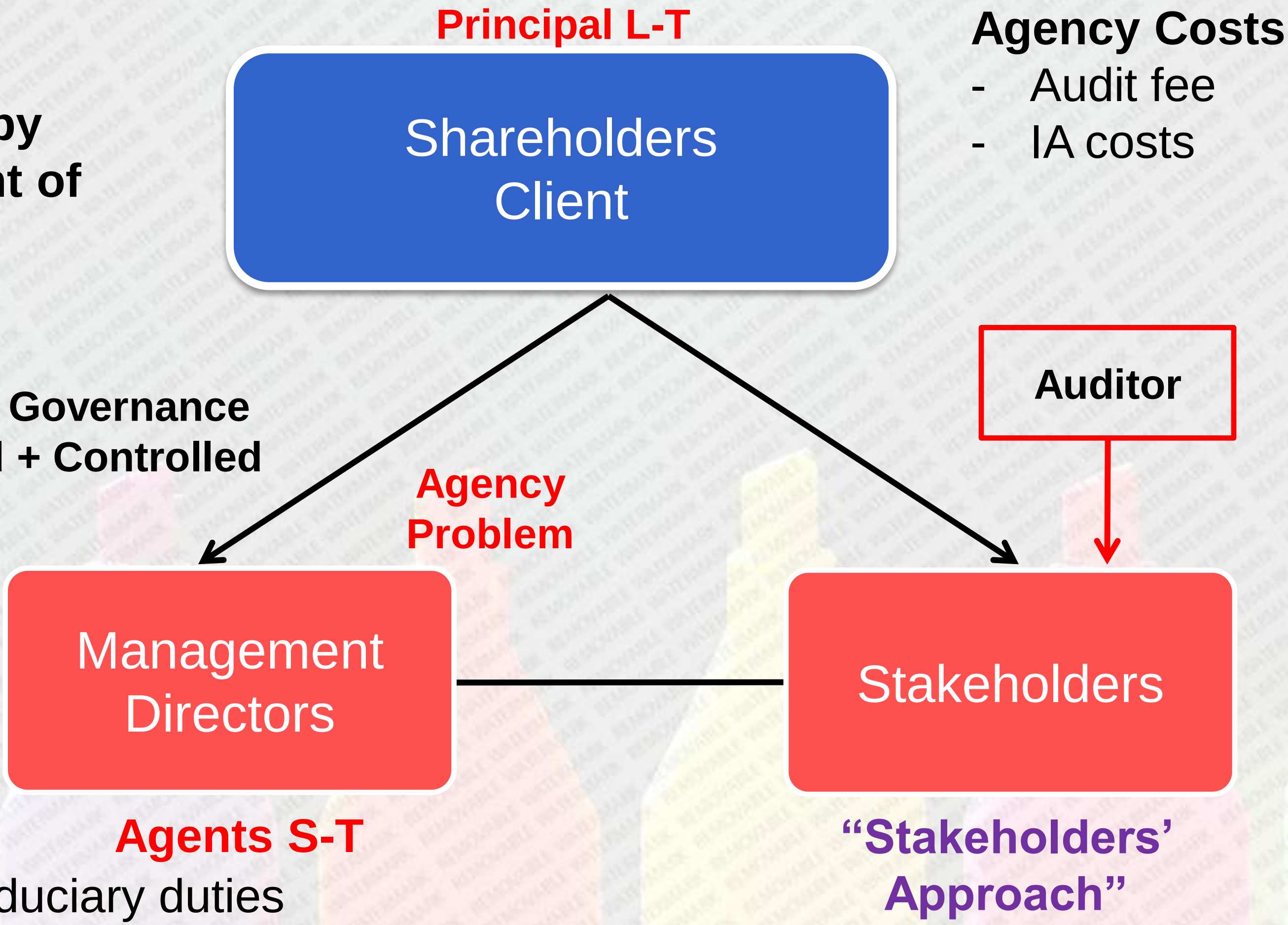
Corporate governance

MC – Corporate governance

Why Corporate Governance?

Resolve by Alignment of interest

Corporate Governance
→ Directed + Controlled



Agency Costs

- Audit fee
- IA costs

MC – Corporate governance

Major Concepts of Corporate Governance

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

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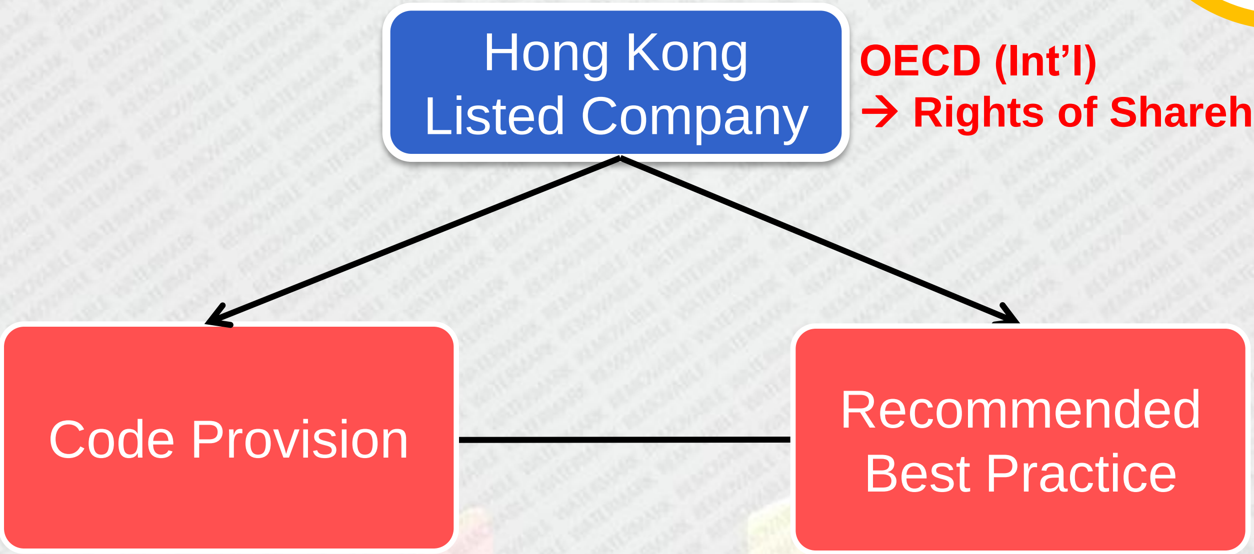
Hong Kong Listed Companies



Hong Kong Listed Company

OECD (Int'l)
→ Rights of Shareholders

Code Provision

Recommended Best Practice

Mandatory

Voluntary Disclosure

Comply or Explain approach –

Non-Compliance : disclose in annual report

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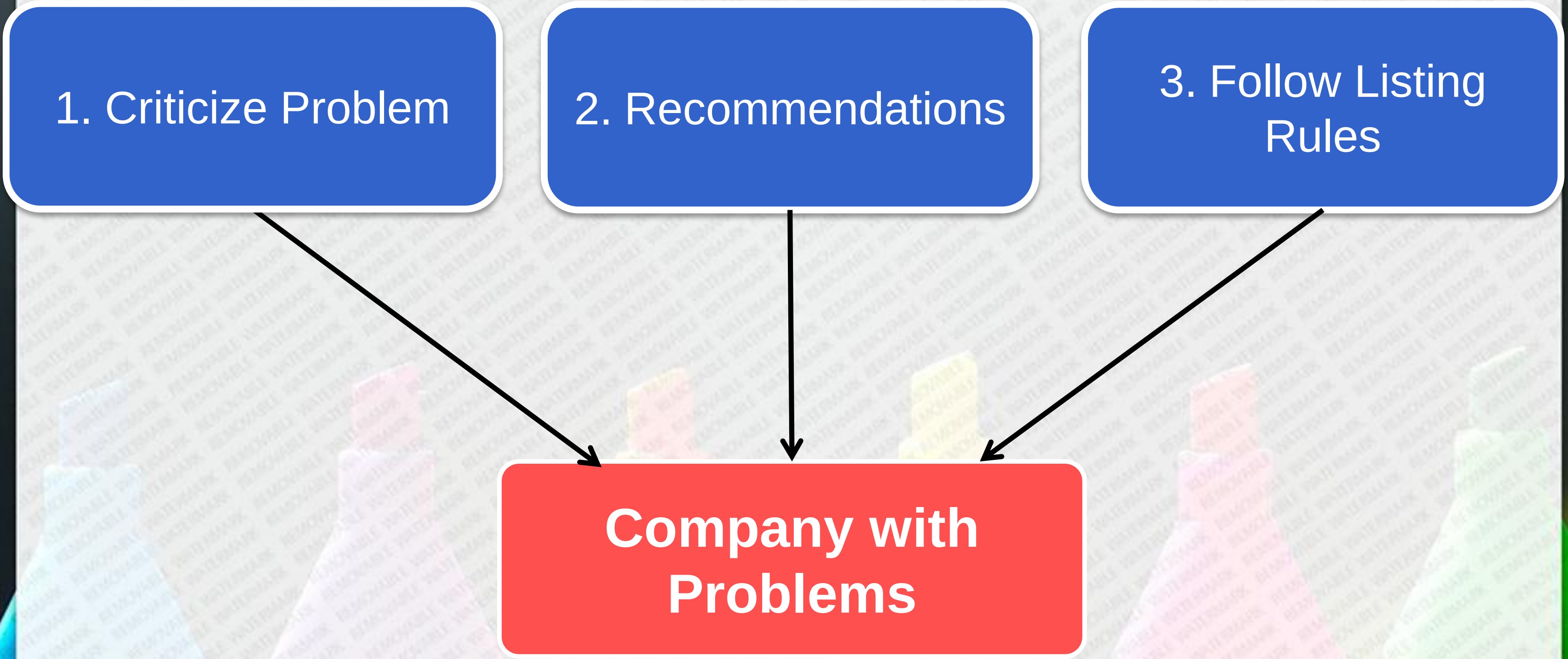
Exam Technique



1. Criticize Problem

2. Recommendations

3. Follow Listing Rules

Company with Problems

MC – Corporate governance

Corporate Governance Concepts I

- **The Board** – effective board / **active interest in the issuer's affairs**

- **Chairman and Chief Executive Officer** – separated a clear division of these responsibilities at the board level.

- **Board composition** – balance of skills and experience appropriate; The new Rule required that at least **one-third** of an issuer's board should be **independent non-executive directors (INEDs)**.

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Corporate Governance Concepts I

- **Appointments, re-election and removal** – formal, considered and transparent procedure for the appointment of new directors to the board.

- **List of directors should be published on the issuer's website**

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Corporate Governance Concepts II

- **An INED who has served nine years**

- **Separate resolution to retain an INED who has served on the board for more than nine years.**

- **Directors should provide records of training they received to issuers.**

- **Board should regularly review the contribution by a director.**

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Corporate Governance Concepts II

- **Supply of and access to information –** Directors should be provided in a timely manner with appropriate information.

- **The board should be responsible for corporate governance.**

- Non-executive directors, including INEDs, should attend board, committee and general meetings and contribute to the issuer's strategy and policies.

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Corporate Governance Concepts III

- **Directors – Remuneration of directors and senior management and Board Evaluation**

- Disclose information relating to its **directors' remuneration policy** and other remuneration related matters. (Disclosed in full in the annual reports and Accounts)

- The company should establish a **remuneration committee**

- **Formal and transparent procedure** for setting policy on executive directors' remuneration

Corporate Governance Concepts III (Cont'd)

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

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Corporate Governance Concepts IV

- **Audit Committee** – The board should establish **formal and transparent arrangements** for considering how it will apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

- Listed company should establish a **shareholder communication policy**.

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Corporate Governance Concepts IV

- **Company Secretary**

- The Company Secretary supports the Chairman in **promoting** the highest standards of corporate governance.

- **Ensuring good information flow** within the board and that board policy and procedures are followed.

- The Company Secretary **reports to the Chairman**

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Corporate Governance Concepts V

- **Auditor attending the AGM**

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

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NEW in Corporate Governance

Board Diversity ("BD")

Implement new measures. In brief, the measures include a Code Provision ("CP") which requires the issuer to have a BD policy, and disclose the policy or its summary in the issuer's corporate governance report, along with any measurable objectives for implementing the policy and progress on achieving those objectives.

Diversity of board members can be achieved through consideration of a number of factors, including but not limited to gender, age, cultural and educational background, or professional experience.

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Corporate Governance [**NEW]

The New Hong Kong Companies Ordinance

The new CO Commenced operation from 3 March 2014.

Under the new CO, there are new measures for enhancing corporate governance and the following are some of the major measures for the enhancement :

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Corporate Governance [**NEW]

a) Strengthening the accountability of directors

Restricting the appointment of corporate directors by requiring every private company to have **at least one natural person** to act as director, to enhance transparency and accountability.

Clarifying in the statute the directors' duty of care, skill and diligence with a view to providing clear guidance to directors.

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Corporate Governance [**NEW]

b) Enhancing shareholder engagement in the decision-making process

Introducing a **comprehensive** **set of rules for proposing and passing a written resolution**.

Requiring a company to bear the expenses of circulating members' statements relating to the business of, and proposed resolutions for, Annual General Meetings, if they are received in time to be sent with the notice of the meeting.

Reducing the threshold requirement for members to demand a poll from 10% to 5% of the total voting rights.

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Corporate Governance [**NEW]

c) Improving the disclosure of company information

Requiring public companies and the larger (ie companies that do not qualify for simplified reporting) private companies and guarantee companies to **prepare a more comprehensive directors' report** which includes an analytical and forward-looking "business review", whilst allowing private companies to opt out by special resolution. The business review will provide useful information for shareholders. In particular, the requirement to include information relating to environmental and employee matters that have a significant effect on the company is in line with international trends to promote corporate social responsibility.

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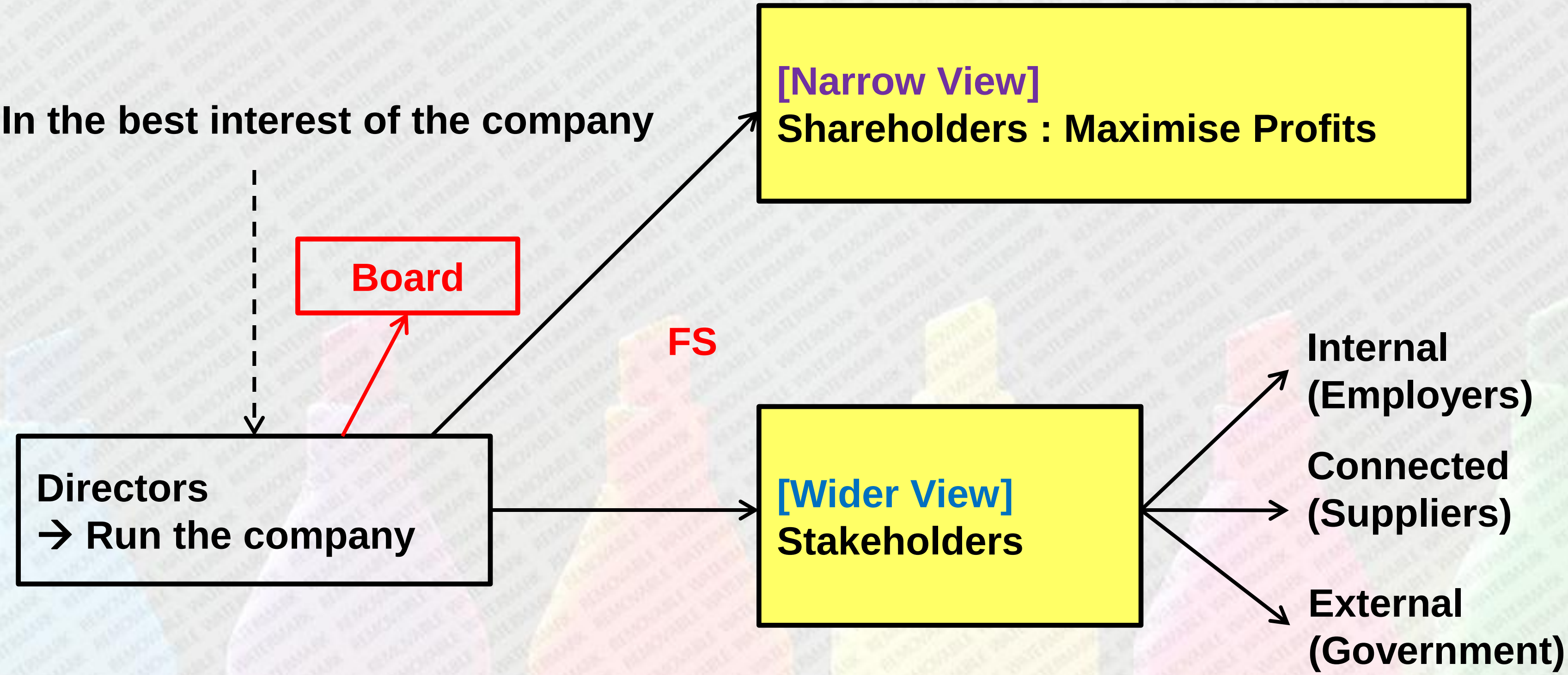
Stakeholders – Narrow View Vs Wider View



In the best interest of the company

[Narrow View]
Shareholders : Maximise Profits

Board

FS

Directors
→ Run the company

[Wider View]
Stakeholders

Internal (Employers)

Connected (Suppliers)

External (Government)

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Open Question –

Does the Company need to adopt stakeholder's approach?

Yes	***No***
Trend → Globally	Too wide
Corporate social responsibility	Too costly to suit everyone
Attract shareholders	No legitimate effects – ie no economic benefits
Increasing internationalization	Culture differences
Avoid corporate scandals	

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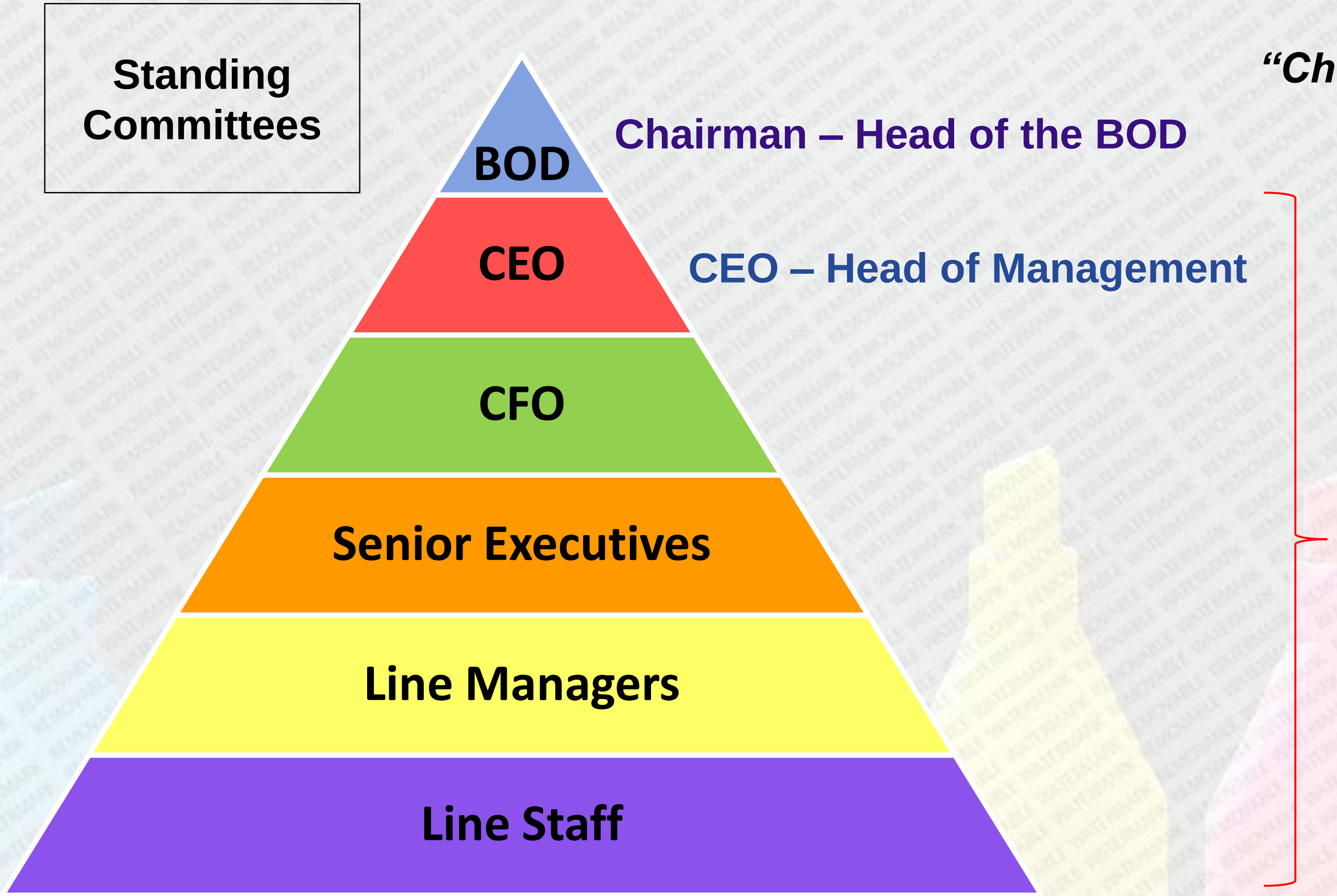
Chairman Vs CEO

“Chairman ≠ CEO”



Chairman – Head of the BOD

CEO – Head of Management

Management Operations

MC – Corporate governance

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Chairman’s Role

- ✓ leader of the board of directors in a private or public company
- ✓ responsible for ensuring the board’s effectiveness
- ✓ setting the board’s agenda and ensuring that board meetings take place
- ✓ “public face” of the organisation
- ✓ communication with shareholders.
- ✓ co-ordinating the contributions of non-executive directors (NEDs) and facilitating good relationships between executive and non-executive directors.

MC – Corporate governance

Standing Committees

Nomination Committee

- NEDs - majority of INEDs
- Nominate directors
- Recommendation to BOD

Remuneration Committee

- NEDs
- Remuneration policy
- Remuneration procedures

Audit Committee

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

Risk Committee

- EDs and NEDs
- Risk policies
- Risk responses

MC – Corporate governance

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The Board

EDs

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

NEDs

- Review / Monitor / Recommendation to BOD
- Board Committee

→ Nomination
→ Remuneration
→ Audit
→ Risk
→ Fixed fee
→ No performance related pay ie bonus or share options

} NEDs

MC – Responses to assessed risk

Executive Training Company
(International) Ltd

Sarbanes - Oxley Act 2002

Sox Act

Enron

“Rules-based Principle”

Mandatory for US Listed Co

MC – Corporate governance

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Major Concepts in SOX

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

Exam Questions Review
Jun 2012 – Case Qu 4
Corporate Governance

MC – Exam Questions Review

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

Question

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

MC – Exam Questions Review

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

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

MC – Exam Questions Review

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

Required:

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

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

MC – Exam Questions Review

[Corporate Governance]
Jun 2012 – Case Answer 4a

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

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

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

MC – Exam Questions Review

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

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

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

MC – Exam Questions Review

[Corporate Governance]
Jun 2012 – Case Answer 4b

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

- **Discuss with the board of directors** the setting up of an independent committee to investigate the causes of the accident.

- **Set up and supervise an independent team** to understand the root cause of the accident.

MC – Exam Questions Review

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

- Supervise the **Internal Audit** to review the operational procedures, identify control deficiencies and any improvement on operation procedures as required.

- **Discussion with the board of directors and / or external advisors** the procedures setting up for claims from those affected.

- **Discuss with legal, finance and accounting departments** / units and the Internal Audit the adequacy of provision and contingency made against the accident and the sufficiency of disclosures made in the quarterly and annual reports.

MC – Exam Questions Review

[Corporate Governance]
Jun 2012 – Case Answer 4c

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

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

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

MC – Exam Questions Review

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

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

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

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Exam Questions Review
Dec 2011 – Case Qu 3
Corporate Governance

MC – Exam Questions Review

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

Question

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

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

MC – Exam Questions Review

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

Required:

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

a) To what extent can the establishment of an effective audit committee improve DREIT's corporate governance in the context of external auditing, financial reporting and internal control? (8 marks)

b) Describe some ways to gauge the effectiveness of DREIT's audit committee. (6 marks)

MC – Exam Questions Review

[Corporate Governance]
Dec 2011 – Case Answer 3a

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

MC – Exam Questions Review

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

Financial reporting

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

MC – Exam Questions Review

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

External auditing

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

MC – Exam Questions Review

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

Internal control

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

MC – Exam Questions Review

[Corporate Governance]
Dec 2011 – Case Answer 3b

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

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

MC – Exam Questions Review

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

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

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

MC – Exam Questions Review

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

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

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HKSA 580 (Clarified)

MC – HKSA 580 (Clarified)

Written representations are written statements by management provided to the auditor to confirm certain matters or to support other audit evidence.

The **objectives** of the auditor:

- To obtain written representations that management believes that it has fulfilled the **fundamental responsibilities** that constitute the premise on which an audit is conducted

MC – HKSA 580 (Clarified)

- To **support other audit evidence** relevant to the financial statements if determined by the auditor or required by other HKSAs

- To **respond appropriately to written representations** or if management does not provide written representations requested by the auditor

MC – HKSA 580 (Clarified)

Written representations as audit evidence

Written representation letter is **written evidence** that is better than oral representations. However, the letter is evidence from within the entity and is **less reliable** than information from independent sources.

If a representation by management is **contradicted by other audit evidence**, the auditors should **investigate** the circumstances and, when necessary, reconsider the reliability of other representations made by management.

MC – HKSA 580 (Clarified)

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Written representation cannot substitute some other evidence

A representation by management as to the quantity and condition of inventories is not a substitute for the same evidence obtained through physical observation

A representation by management as to the existence of trade debtor is not a substitute for the same evidence obtained by trade receivable confirmation.

MC – HKSA 580 (Clarified)

Written representation cannot substitute some other evidence

If management **refuses** to provide representations that auditor requires, this constitutes a limitation on scope and auditor should express a **qualified opinion or a disclaimer of opinion**. The auditor should reconsider the **appropriateness** to rely on other management representations during the audit and should discuss the matter with management. Auditors should re-evaluate the integrity of management.

Exam Techniques for MC

Common Techniques to pass MC

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A. Prepare your critical files

B. Only need 1 set of notes

C. Time yourself

D. Start practice writing

E. Don’t just copy – use key words for application

F. Demonstrate logical thinking – sometimes no right or wrong

G. No need to highlight everything in the question booklet

H. Writing – legible to read

MC Preparation with ETC

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Knowledge Course: 10 Sessions

→ Boost your knowledge

Revision Course: 9 Sessions

→ Practice past papers and other ETC questions

Only got 2 months left – What shall you do?

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

Final Advice

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

Students should:

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

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

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