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

MEMBERS' HANDBOOK

Update No. 223

(Issued 28 December 2018)

VOLUME III

Document Reference and Title	*Instructions*	*Explanations*
Contents of Volume III	Discard the existing pages i - v and replace with the revised pages i - v.	Revised contents page
HONG KONG STANDARDS ON AUDITING		
HKSA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures and Conforming and Consequential Amendments to Other Hong Kong Standards*	Insert after HKSA 540 revised in June 2017.	Note 1
PRACTICE NOTES		
PN 830 (Revised 2018), *Reports by the Auditor Under the Banking Ordinance*	Insert after PN 830 (Revised) revised in April 2016.	Notes 2 and 3

Notes:

1. HKSA 540 (Revised) is issued in response to the release of ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* and *Conforming and Consequential Amendments to Other International Standards Arising from ISA 540 (Revised)* by the International Auditing and Assurance Board in October 2018. The revision ensures that the standard continues to keep pace with the changing market and fosters a more independent and challenging skeptical mindset in auditors.

   HKSA 540 (Revised) will be effective for audits of financial statements for periods beginning on or after 15 December 2019. The conforming and consequential amendments will become effective at the same time as HKSA 540 (Revised).

2. In view of the developments in the banking industry such as regulatory requirements and change in expectations that have taken place over a number of years since the Practice Note ("PN") was originally developed, the Institute's Banking Regulatory Advisory Panel has revised the PN in consultation with the Hong Kong Monetary Authority ("HKMA").

The key changes are made to the following areas:

(a) Level of assurance – enhanced guidance on auditor's work for reporting under s63(3) and s63(3A);

(b) Other reports issued by the auditors under the direction/ instruction of HKMA – provided guidance in paragraph 12b. on the reporting responsibilities of the auditor on other non-statutory reporting engagements requested by the HKMA;

(c) Section 59(2) scoping communication – included guidance on communication with the HKMA to agree on the scoping, nature and extent of work prior to commencement of s59(2) work in paragraph 19a;

(d) Use of IT specialists and other specialists – added more elaboration/ examples in paragraph 81 on the expected nature of work and procedures for "supporting documentation and other information", in particular, when supporting documentation and other information include outputs from computer-based tools;

(e) Conflicts and independence considerations for s59(2) engagements – included additional guidance in paragraph 108 on independence considerations and safeguards;

(f) Version of returns to be reviewed – the returns to be reported on by the auditor is changed from "the returns originally submitted to the HKMA" to "latest returns submitted to the HKMA before the commencement of auditor’s work". Appendix 9 is added for this change;

(g) Materiality – introduced a new "two-tier" materiality approach for auditor's reporting under s63(3), relevant guidance is provided in Appendix 10 to the revised PN;

(h) Additional guidance to certain common specific returns – the procedures for common specific returns originally set out in paragraph 57 of extant PN are moved to Appendix 11 and the guidance for each of the common specific returns is further expanded and elaborated;

(i) Banking (Exposure Limits) Rules ("BELR") – given the commencement of the BELR on 13 July 2018, the relevant paragraphs in the revised PN has been updated accordingly; and

(j) Banking (Liquidity) Rules on net stable funding position – relevant paragraphs in the revised PN has been updated for these new liquidity requirements introduced in January 2018.

<u>The revised PN is effective for reporting periods ending on or after 1 January 2019</u>.

3. In order for readers to easily identify all the changes, the marked-up version of the revised PN is posted at
https://www.hkicpa.org.hk/-/media/Document/SSD/update/changes_update223.pdf

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

MEMBERS' HANDBOOK
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(Updated to December 2018)

Issue/Review date

HKSA 540 (Revised)
Issued December 2018

Effective for audits of financial statements for periods beginning on or after 15 December 2019

Hong Kong Standard on Auditing 540 (Revised)

Auditing Accounting Estimates and Related Disclosures

and

Conforming and Consequential Amendments to Other Hong Kong Standards

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HONG KONG STANDARD ON AUDITING 540 (REVISED)

AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES

(Effective for audits of financial statements for periods beginning on or after 15 December 2019)

CONTENTS

Hong Kong Standard on Auditing (HKSA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, should be read in conjunction with HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*.

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it includes requirements and guidance that refer to, or expand on, how HKSA 315 (Revised),[1] HKSA 330,[2] HKSA 450,[3] HKSA 500[4] and other relevant HKSAs are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias.

Nature of Accounting Estimates

2. Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management and can give rise to complexity in measurement. The effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement. (Ref: Para. A1–A6, Appendix 1)

3. Although this HKSA applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by this HKSA will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by this HKSA would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. This HKSA contains guidance on how the requirements of this HKSA can be scaled. (Ref: Para. A7)

Key Concepts of This HKSA

4. This HKSA requires a separate assessment of inherent risk for purposes of assessing the risks of material misstatement at the assertion level for accounting estimates. Depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in HKSA 200,[5] inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in this HKSA as the spectrum of inherent risk. (Ref: Para. A8–A9, A65–A66, Appendix 1)

5. This HKSA refers to relevant requirements in HKSA 315 (Revised) and HKSA 330, and provides related guidance, to emphasize the importance of the auditor's decisions about controls relating to accounting estimates, including decisions about whether:

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

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

[3] HKSA 450, *Evaluation of Misstatements Identified during the Audit*

[4] HKSA 500, *Audit Evidence*

[5] HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Hong Kong Standards on Auditing*, paragraph A40

- There are controls relevant to the audit, for which the auditor is required to evaluate their design and determine whether they have been implemented.
- To test the operating effectiveness of relevant controls.

6. This HKSA also requires a separate assessment of control risk when assessing the risks of material misstatement at the assertion level for accounting estimates. In assessing control risk, the auditor takes into account whether the auditor's further audit procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not perform tests of controls, the auditor's assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion.[6] (Ref: Para. A10)

7. This HKSA emphasizes that the auditor's further audit procedures (including, where appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.

8. The exercise of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. Similarly, the exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or fraud. (Ref: Para. A11)

9. This HKSA requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable[7] in the context of the applicable financial reporting framework, or are misstated. For purposes of this HKSA, reasonable in the context of the applicable financial reporting framework means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address: (Ref: Para. A12–A13, A139–A144)

    - The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity;
    - The selection of management's point estimate; and
    - The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

Effective Date

10. This HKSA is effective for audits of financial statements for periods beginning on or after 15 December 2019.

Objective

11. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.

Definitions

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

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6 HKSA 530, *Audit Sampling*, Appendix 3

7 See also HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 13(c).

(a) Accounting estimate – A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty. (Ref: Para. A14)

(b) Auditor's point estimate or auditor's range – An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate. (Ref: Para. A15)

(c) Estimation uncertainty – Susceptibility to an inherent lack of precision in measurement. (Ref: Para. A16, Appendix 1)

(d) Management bias – A lack of neutrality by management in the preparation of information. (Ref: Para. A17)

(e) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

(f) Outcome of an accounting estimate – The actual monetary amount that results from the resolution of the transaction(s), event(s) or condition(s) addressed by an accounting estimate. (Ref: Para. A18)

Requirements

Risk Assessment Procedures and Related Activities

13. When obtaining an understanding of the entity and its environment, including the entity's internal control, as required by HKSA 315 (Revised),[8] the auditor shall obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding shall be performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. (Ref: Para. A19–A22)

The Entity and Its Environment

(a) The entity's transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements. (Ref: Para. A23)

(b) The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how transactions and other events or conditions are subject to, or affected by, inherent risk factors. (Ref: Para. A24–A25)

(c) Regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks related to prudential supervision. (Ref: Para. A26)

(d) The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in 13(a)–(c) above. (Ref: Para. A27)

The Entity's Internal Control

(e) The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates. (Ref: Para. A28–A30).

(f) How management identifies the need for, and applies, specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's expert. (Ref: Para. A31)

[8] HKSA 315 (Revised), paragraphs 3, 5–6, 9, 11–12, 15–17, and 20–21

(g) How the entity's risk assessment process identifies and addresses risks relating to accounting estimates. (Ref: Para. A32–A33)

(h) The entity's information system as it relates to accounting estimates, including:

(i) The classes of transactions, events and conditions that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures; and (Ref: Para. A34–A35)

(ii) For such accounting estimates and related disclosures, how management:

a. Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management: (Ref: Para. A36–A37)

i. Selects or designs, and applies, the methods used, including the use of models; (Ref: Para. A38–A39)

ii. Selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; and (Ref: Para. A40–A43)

iii. Selects the data to be used; (Ref: Para. A44)

b. Understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes; and (Ref: Para. A45)

c. Addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements. (Ref: Para. A46–A49)

(i) Control activities relevant to the audit over management's process for making accounting estimates as described in paragraph 13(h)(ii). (Ref: Para. A50–A54)

(j) How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review.

14. The auditor shall review the outcome of previous accounting estimates, or, where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: Para. A55–A60)

15. With respect to accounting estimates, the auditor shall determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained. (Ref: Para. A61–A63)

Identifying and Assessing the Risks of Material Misstatement

16. In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, as required by HKSA 315 (Revised),[9] the auditor shall separately assess inherent risk and control risk. The auditor shall take the following into account in identifying the risks of material misstatement and in assessing inherent risk: (Ref: Para. A64–A71)

(a) The degree to which the accounting estimate is subject to estimation uncertainty; and (Ref: Para. A72–A75)

9 HKSA 315 (Revised), paragraphs 25 and 26

(b) The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: Para. A76–A79)

(i) The selection and application of the method, assumptions and data in making the accounting estimate; or

(ii) The selection of management's point estimate and related disclosures for inclusion in the financial statements.

17. The auditor shall determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 16 are, in the auditor's judgment, a significant risk.[10] If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk.[11] (Ref: Para. A80)

Responses to the Assessed Risks of Material Misstatement

18. As required by HKSA 330,[12] the auditor's further audit procedures shall be responsive to the assessed risks of material misstatement at the assertion level,[13] considering the reasons for the assessment given to those risks. The auditor's further audit procedures shall include one or more of the following approaches:

(a) Obtaining audit evidence from events occurring up to the date of the auditor's report (see paragraph 21);

(b) Testing how management made the accounting estimate (see paragraphs 22–27); or

(c) Developing an auditor's point estimate or range (see paragraphs 28–29).

The auditor's further audit procedures shall take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.[14] The auditor shall design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. (Ref: Para. A81–A84)

19. As required by HKSA 330,[15] the auditor shall design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls, if:

(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively; or

(b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In relation to accounting estimates, the auditor's tests of such controls shall be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.[16] (Ref: Para. A85–A89)

20. For a significant risk relating to an accounting estimate, the auditor's further audit procedures shall include tests of controls in the current period if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.[17] (Ref: Para. A90)

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[10] HKSA 315 (Revised), paragraph 27

[11] HKSA 315 (Revised), paragraph 29

[12] HKSA 330, paragraphs 6–15 and 18

[13] HKSA 330, paragraphs 6–7 and 21

[14] HKSA 330, paragraph 7(b)

[15] HKSA 330, paragraph 8

[16] HKSA 330, paragraph 9

[17] HKSA 330, paragraphs 15 and 21

Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor's Report

21. When the auditor's further audit procedures include obtaining audit evidence from events occurring up to the date of the auditor's report, the auditor shall evaluate whether such audit evidence is sufficient and appropriate to address the risks of material misstatement relating to the accounting estimate, taking into account that changes in circumstances and other relevant conditions between the event and the measurement date may affect the relevance of such audit evidence in the context of the applicable financial reporting framework. (Ref: Para. A91–A93)

Testing How Management Made the Accounting Estimate

22. When testing how management made the accounting estimate, the auditor's further audit procedures shall include procedures, designed and performed in accordance with paragraphs 23–26, to obtain sufficient appropriate audit evidence regarding the risks of material misstatement relating to: (Ref: Para. A94)

    (a) The selection and application of the methods, significant assumptions and the data used by management in making the accounting estimate; and

    (b) How management selected the point estimate and developed related disclosures about estimation uncertainty.

Methods

23. In applying the requirements of paragraph 22, with respect to methods, the auditor's further audit procedures shall address:

    (a) Whether the method selected is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from the method used in prior periods are appropriate; (Ref: Para. A95, A97)

    (b) Whether judgments made in selecting the method give rise to indicators of possible management bias; (Ref: Para. A96)

    (c) Whether the calculations are applied in accordance with the method and are mathematically accurate;

    (d) When management's application of the method involves complex modelling, whether judgments have been applied consistently and whether, when applicable: (Ref: Para. A98–A100)

        (i) The design of the model meets the measurement objective of the applicable financial reporting framework, is appropriate in the circumstances, and, if applicable, changes from the prior period's model are appropriate in the circumstances; and

        (ii) Adjustments to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances; and

    (e) Whether the integrity of the significant assumptions and the data has been maintained in applying the method. (Ref: Para. A101)

Significant Assumptions

24. In applying the requirements of paragraph 22, with respect to significant assumptions, the auditor's further audit procedures shall address:

    (a) Whether the significant assumptions are appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate; (Ref: Para. A95, A102–A103)

    (b) Whether judgments made in selecting the significant assumptions give rise to indicators of possible management bias; (Ref: Para. A96)

    (c) Whether the significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit; and (Ref: Para. A104)

(d) When applicable, whether management has the intent to carry out specific courses of action and has the ability to do so. (Ref: Para. A105)

Data

25. In applying the requirements of paragraph 22, with respect to data, the auditor's further audit procedures shall address:

(a) Whether the data is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate (Ref: Para. A95, A106);

(b) Whether judgments made in selecting the data give rise to indicators of possible management bias; (Ref: Para. A96)

(c) Whether the data is relevant and reliable in the circumstances; and (Ref: Para. A107)

(d) Whether the data has been appropriately understood or interpreted by management, including with respect to contractual terms. (Ref: Para. A108)

Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty

26. In applying the requirements of paragraph 22, the auditor's further audit procedures shall address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to:

(a) Understand estimation uncertainty; and (Ref: Para. A109)

(b) Address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty. (Ref: Para. A110–A114)

27. When, in the auditor's judgment based on the audit evidence obtained, management has not taken appropriate steps to understand or address estimation uncertainty, the auditor shall: (Ref: Para. A115–A117)

(a) Request management to perform additional procedures to understand estimation uncertainty or to address it by reconsidering the selection of management's point estimate or considering providing additional disclosures relating to the estimation uncertainty, and evaluate management's response(s) in accordance with paragraph 26;

(b) If the auditor determines that management's response to the auditor's request does not sufficiently address estimation uncertainty, to the extent practicable, develop an auditor's point estimate or range in accordance with paragraphs 28–29; and

(c) Evaluate whether a deficiency in internal control exists and, if so, communicate in accordance with HKSA 265.[18]

Developing an Auditor's Point Estimate or Range

28. When the auditor develops a point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty, including when required by paragraph 27(b), the auditor's further audit procedures shall include procedures to evaluate whether the methods, assumptions or data used are appropriate in the context of the applicable financial reporting framework. Regardless of whether the auditor uses management's or the auditor's own methods, assumptions or data, these further audit procedures shall be designed and performed to address the matters in paragraphs 23–25. (Ref: Para. A118–A123)

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

29. If the auditor develops an auditor's range, the auditor shall:

    (a) Determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework; and (Ref: Para. A124–A125)

    (b) Design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement relating to the disclosures in the financial statements that describe the estimation uncertainty.

Other Considerations Relating to Audit Evidence

30. In obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, irrespective of the sources of information to be used as audit evidence, the auditor shall comply with the relevant requirements in HKSA 500.

    When using the work of a management's expert, the requirements in paragraphs 21–29 of this HKSA may assist the auditor in evaluating the appropriateness of the expert's work as audit evidence for a relevant assertion in accordance with paragraph 8(c) of HKSA 500. In evaluating the work of the management's expert, the nature, timing and extent of the further audit procedures are affected by the auditor's evaluation of the expert's competence, capabilities and objectivity, the auditor's understanding of the nature of the work performed by the expert, and the auditor's familiarity with the expert's field of expertise. (Ref: Para. A126–A132)

Disclosures Related to Accounting Estimates

31. The auditor shall design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate, other than those related to estimation uncertainty addressed in paragraphs 26(b) and 29(b).

Indicators of Possible Management Bias

32. The auditor shall evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit. Where there is intention to mislead, management bias is fraudulent in nature. (Ref: Para. A133–A136)

Overall Evaluation Based on Audit Procedures Performed

33. In applying HKSA 330 to accounting estimates,[19] the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A137–A138)

    (a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified;

    (b) Management's decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework; and

    (c) Sufficient appropriate audit evidence has been obtained.

[19] HKSA 330, paragraphs 25–26

34. In making the evaluation required by paragraph 33(c), the auditor shall take into account all relevant audit evidence obtained, whether corroborative or contradictory.[20] If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall evaluate the implications for the audit or the auditor's opinion on the financial statements in accordance with HKSA 705 (Revised).[21]

Determining Whether the Accounting Estimates are Reasonable or Misstated

35. The auditor shall determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. HKSA 450[22] provides guidance on how the auditor may distinguish misstatements (whether factual, judgmental, or projected) for the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. (Ref: Para. A12–A13, A139–A144)

36. In relation to accounting estimates, the auditor shall evaluate:

(a) In the case of a fair presentation framework, whether management has included disclosures, beyond those specifically required by the framework, that are necessary to achieve the fair presentation of the financial statements as a whole;[23] or

(b) In the case of a compliance framework, whether the disclosures are those that are necessary for the financial statements not to be misleading.[24]

Written Representations

37. The auditor shall request written representations from management[25] and, when appropriate, those charged with governance about whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement or disclosure that is in accordance with the applicable financial reporting framework. The auditor shall also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions, or data used. (Ref: Para. A145)

Communication with Those Charged With Governance, Management, or Other Relevant Parties

38. In applying HKSA 260 (Revised)[26] and HKSA 265,[27] the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively. In doing so, the auditor shall consider the matters, if any, to communicate regarding accounting estimates and take into account whether the reasons given to the risks of material misstatement relate to estimation uncertainty, or the effects of complexity, subjectivity or other inherent risk factors in making accounting estimates and related disclosures. In addition, in certain circumstances, the auditor is required by law or regulation to communicate about certain matters with other relevant parties, such as regulators or prudential supervisors. (Ref: Para. A146–A148)

Documentation

39. The auditor shall include in the audit documentation:[28] (Ref: Para. A149–A152)

(a) Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates;

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20 HKSA 500, paragraph 11

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

22 HKSA 450, paragraph A6

23 See also HKSA 700 (Revised), paragraph 14.

24 See also HKSA 700 (Revised), paragraph 19.

25 HKSA 580, *Written Representations*

26 HKSA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16(a)

27 HKSA 265, paragraph 9

28 HKSA 230, *Audit Documentation*, paragraphs 8–11, A6, A7 and A10

(b) The linkage of the auditor’s further audit procedures with the assessed risks of material misstatement at the assertion level,[29] taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks;

(c) The auditor’s response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;

(d) Indicators of possible management bias related to accounting estimates, if any, and the auditor’s evaluation of the implications for the audit, as required by paragraph 32; and

(e) Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

Conformity and Compliance with International Standards on Auditing

40. As of December 2018 (date of issue), this HKSA conforms with International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*. Compliance with the requirements of this HKSA ensures compliance with ISA 540 (Revised).

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Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

Examples of Accounting Estimates

A1. Examples of accounting estimates related to classes of transactions, account balances and disclosures include:

- Inventory obsolescence.
- Depreciation of property and equipment.
- Valuation of infrastructure assets.
- Valuation of financial instruments.
- Outcome of pending litigation.
- Provision for expected credit losses.
- Valuation of insurance contract liabilities.
- Warranty obligations.
- Employee retirement benefits liabilities.
- Share-based payments.
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets.
- Impairment of long-lived assets or property or equipment held for disposal.
- Non-monetary exchanges of assets or liabilities between independent parties.
- Revenue recognized for long-term contracts.

Methods

A2. A method is a measurement technique used by management to make an accounting estimate in accordance with the required measurement basis. For example, one recognized method used to make accounting estimates relating to share-based payment transactions is to determine a theoretical option call price using the Black-Scholes option pricing formula. A

[29] HKSA 330, paragraph 28(b)

method is applied using a computational tool or process, sometimes referred to as a model, and involves applying assumptions and data and taking into account a set of relationships between them.

Assumptions and Data

A3. Assumptions involve judgments based on available information about matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events. An assumption may be selected by management from a range of appropriate alternatives. Assumptions that may be made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate.

A4. For purposes of this HKSA, data is information that can be obtained through direct observation or from a party external to the entity. Information obtained by applying analytical or interpretive techniques to data is referred to as derived data when such techniques have a well-established theoretical basis and therefore less need for management judgment. Otherwise, such information is an assumption.

A5. Examples of data include:

- Prices agreed in market transactions;
- Operating times or quantities of output from a production machine;
- Historical prices or other terms included in contracts, such as a contracted interest rate, a payment schedule, and term included in a loan agreement;
- Forward-looking information such as economic or earnings forecasts obtained from an external information source, or
- A future interest rate determined using interpolation techniques from forward interest rates (derived data).

A6. Data can come from a wide range of sources. For example, data can be:

- Generated within the organization or externally;
- Obtained from a system that is either within or outside the general or subsidiary ledgers;
- Observable in contracts; or
- Observable in legislative or regulatory pronouncements.

Scalability (Ref: Para. 3)

A7. Examples of paragraphs that include guidance on how the requirements of this HKSA can be scaled include paragraphs A20–A22, A63, A67, and A84.

Key Concepts of This HKSA

Inherent Risk Factors (Ref: Para. 4)

A8. Inherent risk factors are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls. Appendix 1 further explains the nature of these inherent risk factors, and their inter-relationships, in the context of making accounting estimates and their presentation in the financial statements.

A9. In addition to the inherent risk factors of estimation uncertainty, complexity or subjectivity, other inherent risk factors that the auditor may consider in identifying and assessing the risks of material misstatement may include the extent to which the accounting estimate is subject to, or affected by:

- Change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework which may give rise to the need for changes in the method, assumptions or data used to make the accounting estimate.

- Susceptibility to misstatement due to management bias or fraud in making the accounting estimate.

Control Risk (Ref: Para. 6)

A10. An important consideration for the auditor in assessing control risk at the assertion level is the effectiveness of the design of the controls that the auditor intends to rely on and the extent to which the controls address the assessed inherent risks at the assertion level. The auditor's evaluation that controls are effectively designed and have been implemented supports an expectation about the operating effectiveness of the controls in determining whether to test them.

Professional Skepticism (Ref: Para. 8)

A11. Paragraphs A60, A95, A96, A137 and A139 are examples of paragraphs that describe ways in which the auditor can exercise professional skepticism. Paragraph A152 provides guidance on ways in which the auditor's exercise of professional skepticism may be documented, and includes examples of specific paragraphs in this HKSA for which documentation may provide evidence of the exercise of professional skepticism.

Concept of "Reasonable" (Ref: Para. 9, 35)

A12. Other considerations that may be relevant to the auditor's consideration of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework include whether:

- The data and assumptions used in making the accounting estimate are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities; and
- The accounting estimate takes into account appropriate information as required by the applicable financial reporting framework.

A13. The term "applied appropriately" as used in paragraph 9 means in a manner that not only complies with the requirements of the applicable financial reporting framework but, in doing so, reflects judgments that are consistent with the objective of the measurement basis in that framework.

Definitions

Accounting Estimate (Ref: Para. 12(a))

A14. Accounting estimates are monetary amounts that may be related to classes of transactions or account balances recognized or disclosed in the financial statements. Accounting estimates also include monetary amounts included in disclosures or used to make judgments about recognition or disclosure relating to a class of transactions or account balance.

Auditor's Point Estimate or Auditor's Range (Ref: Para. 12(b))

A15. An auditor's point estimate or range may be used to evaluate an accounting estimate directly (for example, an impairment provision or the fair value of different types of financial instruments), or indirectly (for example, an amount to be used as a significant assumption for an accounting estimate). A similar approach may be taken by the auditor in developing an amount or range of amounts in evaluating a non-monetary item of data or an assumption (for example, an estimated useful life of an asset).

Estimation Uncertainty (Ref: Para. 12(c))

A16. Not all accounting estimates are subject to a high degree of estimation uncertainty. For example, some financial statement items may have an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

Management Bias (Ref: Para. 12(d))

A17. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Estimation uncertainty gives rise to subjectivity in making an accounting estimate. The presence of subjectivity gives rise to the need for judgment by management and the susceptibility to unintentional or intentional management bias (for example, as a result of motivation to achieve a desired profit target or capital ratio). The susceptibility of an accounting estimate to management bias increases with the extent to which there is subjectivity in making the accounting estimate.

Outcome of an Accounting Estimate (Ref: Para. 12(f))

A18. Some accounting estimates, by their nature, do not have an outcome that is relevant for the auditor's work performed in accordance with this HKSA. For example, an accounting estimate may be based on perceptions of market participants at a point in time. Accordingly, the price realized when an asset is sold or a liability is transferred may differ from the related accounting estimate made at the reporting date because, with the passage of time, the market participants' perceptions of value have changed.

Risk Assessment Procedures and Related Activities

Obtaining an Understanding of the Entity and Its Environment (Ref: Para. 13)

A19. Paragraphs 11–24 of HKSA 315 (Revised) require the auditor to obtain an understanding of certain matters about the entity and its environment, including the entity's internal control. The requirements in paragraph 13 of this HKSA relate more specifically to accounting estimates and build on the broader requirements in HKSA 315 (Revised).

Scalability

A20. The nature, timing and extent of the auditor's procedures to obtain the understanding of the entity and its environment, including the entity's internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matter(s) apply in the circumstances. For example, the entity may have few transactions or other events and conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree and there may be fewer controls relevant to the audit. If so, the auditor's risk assessment procedures are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements and simple walk-throughs of management's process for making the accounting estimate.

A21. By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system, and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or be more extensive, than in the circumstances in paragraph A20.

A22. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities:

- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.

- Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

The Entity and Its Environment

The entity's transactions and other events and conditions (Ref: Para. 13(a))

A23. Changes in circumstances that may give rise to the need for, or changes in, accounting estimates may include, for example, whether:

- The entity has engaged in new types of transactions;
- Terms of transactions have changed; or
- New events or conditions have occurred.

The requirements of the applicable financial reporting framework (Ref: Para. 13(b))

A24. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied those requirements relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework not to be the most appropriate in the circumstances of the entity.[30]

A25. In obtaining this understanding, the auditor may seek to understand whether:

- The applicable financial reporting framework:
  - o Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates;
  - o Specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability; or
  - o Specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and
- Changes in the applicable financial reporting framework require changes to the entity's accounting policies relating to accounting estimates.

Regulatory factors (Ref: Para. 13(c))

A26. Obtaining an understanding of regulatory factors, if any, that are relevant to accounting estimates may assist the auditor in identifying applicable regulatory frameworks (for example, regulatory frameworks established by prudential supervisors in the banking or insurance industries) and in determining whether such regulatory framework(s):

- Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon;
- Specifies, or provides guidance about, disclosures in addition to the requirements of the applicable financial reporting framework;
- Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements; or

[30] HKSA 260 (Revised), paragraph 16(a)

- Contains requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting framework, which may indicate potential risks of material misstatement. For example, some regulators may seek to influence minimum levels for expected credit loss provisions that exceed those required by the applicable financial reporting framework.

The nature of the accounting estimates and related disclosures that the auditor expects to be included in the financial statements (Ref: Para. 13(d))

A27. Obtaining an understanding of the nature of accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements assists the auditor in understanding the measurement basis of such accounting estimates and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management makes the accounting estimates.

The Entity's Internal Control Relevant to the Audit

The nature and extent of oversight and governance (Ref: Para. 13(e))

A28. In applying HKSA 315 (Revised),[31] the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for making accounting estimates may be important to the auditor's required evaluation as it relates to whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are undermined by deficiencies in the control environment.

A29. The auditor may obtain an understanding of whether those charged with governance:

- Have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or information technology used in making the accounting estimates;
- Have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework;
- Are independent from management, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to call into question management's actions when those actions appear to be inadequate or inappropriate;
- Oversee management's process for making the accounting estimates, including the use of models; or
- Oversee the monitoring activities undertaken by management. This may include supervision and review procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls over the accounting estimates.

A30. Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that:

- Require significant judgment by management to address subjectivity;
- Have high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information technology, large volumes of data or the use of multiple data sources or assumptions with complex interrelationships;

31 HKSA 315 (Revised), paragraph 14

- Had, or ought to have had, a change in the method, assumptions or data compared to previous periods; or
- Involve significant assumptions.

Management's application of specialized skills or knowledge, including the use of management's experts (Ref: Para. 13(f))

A31. The auditor may consider whether the following circumstances increase the likelihood that management needs to engage an expert:[32]

- The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms.
- The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 fair values.[33]
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

The entity's risk assessment process (Ref: Para. 13(g))

A32. Understanding how the entity's risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in:

- The requirements of the applicable financial reporting framework related to the accounting estimates;
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used;
- The entity's information system or IT environment; and
- Key personnel.

A33. Matters that the auditor may consider in obtaining an understanding of how management identified and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether and, if so, how management:

- Pays particular attention to selecting or applying the methods, assumptions and data used in making accounting estimates.
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
- Identifies financial or other incentives that may be a motivation for bias.
- Monitors the need for changes in the methods, significant assumptions or the data used in making accounting estimates.
- Establishes appropriate oversight and review of models used in making accounting estimates.
- Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates.

The entity's information system relating to accounting estimates (Ref: Para. 13(h)(i))

A34. The classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the classes of transactions, events and conditions relating to accounting estimates and related disclosures that are subject to paragraphs 18(a) and (d) of HKSA 315

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[32] HKSA 500, paragraph 8

[33] See, for example, Hong Kong Financial Reporting Standard (HKFRS) 13, *Fair Value Measurement*.

(Revised). In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider:

- Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.
- How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities.

A35. During the audit, the auditor may identify classes of transactions, events and conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. HKSA 315 (Revised) deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment process.[34]

Management's identification of the relevant methods, assumptions and sources of data (Ref: Para. 13(h)(ii)(a)

A36. If management has changed the method for making an accounting estimate, considerations may include whether the new method is, for example, more appropriate, is itself a response to changes in the environment or circumstances affecting the entity, or to changes in the requirements of the applicable financial reporting framework or regulatory environment, or whether management has another valid reason.

A37. If management has not changed the method for making an accounting estimate, considerations may include whether the continued use of the previous methods, assumptions and data is appropriate in view of the current environment or circumstances.

Methods (Ref: Para. 13(h)(ii)(a)(i))

A38. The applicable financial reporting framework may prescribe the method to be used in making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method, or the required measurement basis prescribes, or allows, the use of alternative methods.

Models

A39. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of control activities relevant to the audit include the following:

- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:
    - The model's theoretical soundness;
    - The model's mathematical integrity; and
    - The accuracy and completeness of the data and the appropriateness of data and assumptions used in the model;
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;

[34] HKSA 315 (Revised), paragraph 17

- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

Assumptions (Ref: Para. 13(h)(ii)(a)(ii))

A40. Matters that the auditor may consider in obtaining an understanding of how management selected the assumptions used in making the accounting estimates include, for example:

- The basis for management's selection and the documentation supporting the selection of the assumption. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption.
- How management assesses whether the assumptions are relevant and complete.
- When applicable, how management determines that the assumptions are consistent with each other, with those used in other accounting estimates or areas of the entity's business activities, or with other matters that are:
  - Within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and whether they are consistent with the entity's business plans and the external environment; and
  - Outside the control of management (for example, assumptions about interest rates, mortality rates or potential judicial or regulatory actions).
- The requirements of the applicable financial reporting framework related to the disclosure of assumptions.

A41. With respect to fair value accounting estimates, assumptions vary in terms of the sources of the data and the basis for the judgments to support them, as follows:

(a) Those that reflect what marketplace participants would use in pricing an asset or liability, developed based on market data obtained from sources independent of the reporting entity.

(b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability, developed based on the best data available in the circumstances.

In practice, however, the distinction between (a) and (b) may not always be apparent and distinguishing between them depends on understanding the sources of data and the basis for the judgments that support the assumption. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A42. Assumptions used in making an accounting estimate are referred to as significant assumptions in this HKSA if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate. A sensitivity analysis may be useful in demonstrating the degree to which the measurement varies based on one or more assumptions used in making the accounting estimate.

Inactive or illiquid markets

A43. When markets are inactive or illiquid, the auditor's understanding of how management selects assumptions may include understanding whether management has:

- Implemented appropriate policies for adapting the application of the method in such circumstances. Such adaptation may include making model adjustments or developing new models that are appropriate in the circumstances;

- Resources with the necessary skills or knowledge to adapt or develop a model, if necessary on an urgent basis, including selecting the valuation technique that is appropriate in such circumstances;
- The resources to determine the range of outcomes, given the uncertainties involved, for example by performing a sensitivity analysis;
- The means to assess how, when applicable, the deterioration in market conditions has affected the entity's operations, environment and relevant business risks and the implications for the entity's accounting estimates, in such circumstances; and
- An appropriate understanding of how the price data, and the relevance thereof, from particular external information sources may vary in such circumstances.

Data (Ref: Para. 13(h)(ii)(a)(iii))

A44. Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include:

- The nature and source of the data, including information obtained from an external information source.
- How management evaluates whether the data is appropriate.
- The accuracy and completeness of the data.
- The consistency of the data used with data used in previous periods.
- The complexity of the information technology systems used to obtain and process the data, including when this involves handling large volumes of data.
- How the data is obtained, transmitted and processed and how its integrity is maintained.

How management understands and addresses estimation uncertainty (Ref: Para. 13(h)(ii)(b)–13(h)(ii)(c))

A45. Matters that may be appropriate for the auditor to consider relating to whether and how management understands the degree of estimation uncertainty include, for example:

- Whether and, if so, how management identified alternative methods, significant assumptions or sources of data that are appropriate in the context of the applicable financial reporting framework.
- Whether and, if so, how management considered alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the significant assumptions or the data used in making the accounting estimate.

A46. The requirements of the applicable financial reporting framework may specify the approach to selecting management's point estimate from the reasonably possible measurement outcomes. Financial reporting frameworks may recognize that the appropriate amount is one that is appropriately selected from the reasonably possible measurement outcomes and, in some cases, may indicate that the most relevant amount may be in the central part of that range.

A47. For example, with respect to fair value estimates, HKFRS 13[35] indicates that, if multiple valuation techniques are used to measure fair value, the results (i.e., respective indications of fair value) shall be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. In other cases, the applicable financial reporting framework may specify the use of a probability-weighted average of the reasonably possible measurement outcomes, or of the measurement amount that is most likely or that is more likely than not.

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[35] HKFRS 13, Fair Value Measurement, paragraph 63

A48. The applicable financial reporting framework may prescribe disclosures or disclosure objectives related to accounting estimates, and some entities may choose to disclose additional information. These disclosures or disclosure objectives may address, for example:

- The method of estimation used, including any applicable model and the basis for its selection.
- Information that has been obtained from models, or from other calculations used to determine estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
  - Assumptions developed internally; or
  - Data, such as interest rates, that are affected by factors outside the control of the entity.
- The effect of any changes to the method of estimation from the prior period.
- The sources of estimation uncertainty.
- Fair value information.
- Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.

A49. In some cases, the applicable financial reporting framework may require specific disclosures regarding estimation uncertainty, for example:

- The disclosure of information about the assumptions made about the future and other major sources of estimation uncertainty that give rise to a higher likelihood or magnitude of material adjustment to the carrying amounts of assets and liabilities after the period end. Such requirements may be described using terms such as “Key Sources of Estimation Uncertainty” or “Critical Accounting Estimates.” They may relate to accounting estimates that require management’s most difficult, subjective or complex judgments. Such judgments may be more subjective and complex, and accordingly the potential for a consequential material adjustment to the carrying amounts of assets and liabilities may increase, with the number of items of data and assumptions affecting the possible future resolution of the estimation uncertainty. Information that may be disclosed includes:
  - The nature of the assumption or other source of estimation uncertainty;
  - The sensitivity of carrying amounts to the methods and assumptions used, including the reasons for the sensitivity;
  - The expected resolution of an uncertainty and the range of reasonably possible outcomes in respect of the carrying amounts of the assets and liabilities affected; and
  - An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of specific information, such as:
  - Information regarding the significance of fair value accounting estimates to the entity’s financial position and performance; and
  - Disclosures regarding market inactivity or illiquidity.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.

- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

Control activities relevant to the audit over management's process for making accounting estimates (Ref: Para 13(i))

A50. The auditor's judgment in identifying controls relevant to the audit, and therefore the need to evaluate the design of those controls and determine whether they have been implemented, relates to management's process described in paragraph 13(h)(ii). The auditor may not identify relevant control activities in relation to all the elements of paragraph 13(h)(ii), depending on the complexity associated with the accounting estimate.

A51. As part of obtaining an understanding of the control activities relevant to the audit, the auditor may consider:

- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.
- The effectiveness of the design of the control activities. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for, and the nature of, the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.

A52. When management makes extensive use of information technology in making an accounting estimate, controls relevant to the audit are likely to include general IT controls and application controls. Such controls may address risks related to:

- Whether the information technology system has the capability and is appropriately configured to process large volumes of data;
- Complex calculations in applying a method. When diverse systems are required to process complex transactions, regular reconciliations between the systems are made, in particular when the systems do not have automated interfaces or may be subject to manual intervention;
- Whether the design and calibration of models is periodically evaluated;
- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources;
- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting estimates, the maintenance of the integrity and security of the data.
- When using external information sources, risks related to processing or recording the data;

- Whether management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models; and
- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

A53. In some industries, such as banking or insurance, the term governance may be used to describe activities within the control environment, monitoring of controls, and other components of internal control, as described in HKSA 315 (Revised).[36]

A54. For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of:

- The nature and extent of management's use of accounting estimates;
- The design and implementation of control activities that address the risks related to the data, assumptions and models used to make the accounting estimates;
- The aspects of the entity's information system that generate the data on which the accounting estimates are based; and
- How new risks relating to accounting estimates are identified, assessed and managed.

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: Para. 14)

A55. A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realization of the asset or liability in the current period, or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain:

- Information regarding the effectiveness of management's previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management's current process.
- Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial statements.
- Information regarding the complexity or estimation uncertainty pertaining to the accounting estimates.
- Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A56. A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period's financial statements, or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period.

A57. A retrospective review of management judgments and assumptions related to significant accounting estimates is required by HKSA 240.[37] As a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with this HKSA may be carried out in conjunction with the review required by HKSA 240.

A58. Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the

[36] HKSA 315 (Revised) paragraph A77

[37] HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii)

detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projections) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.

A60. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. However, such a difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.[38] Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may reassess control risk and may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

Specialized Skills or Knowledge (Ref: Para. 15)

A61. Matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge, include, for example:[39]

- The nature of the accounting estimates for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance contract liabilities).
- The degree of estimation uncertainty.
- The complexity of the method or model used.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice or areas where there are inconsistencies in how accounting estimates are made.
- The procedures the auditor intends to undertake in responding to assessed risks of material misstatement.
- The need for judgment about matters not specified by the applicable financial reporting framework.
- The degree of judgment needed to select data and assumptions.
- The complexity and extent of the entity's use of information technology in making accounting estimates.

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

[39] HKSA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14 and HKSA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

The nature, timing and extent of the involvement of individuals with specialized skills and knowledge may vary throughout the audit.

A62. The auditor may not possess the specialized skills or knowledge necessary when the matter involved is in a field other than accounting or auditing (for example, valuation skills) and may need to use an auditor's expert.[40]

A63. Many accounting estimates do not require the application of specialized skills or knowledge. For example, specialized skills or knowledge may not be needed for a simple inventory obsolescence calculation. However, for example, for expected credit losses of a banking institution or an insurance contract liability for an insurance entity, the auditor is likely to conclude that it is necessary to apply specialized skills or knowledge.

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 4, 16)

A64. Identifying and assessing risks of material misstatement at the assertion level relating to accounting estimates is important for all accounting estimates, including not only those that are recognized in the financial statements, but also those that are included in the notes to the financial statements.

A65. Paragraph A42 of HKSA 200 states that the HKSAs do not ordinarily refer to inherent risk and control risk separately. However, this HKSA requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement, including significant risks, at the assertion level for accounting estimates in accordance with HKSA 330.[41]

A66. In identifying the risks of material misstatement and in assessing inherent risk, the auditor is required to take into account the degree to which the accounting estimate is subject to, or affected by, estimation uncertainty, complexity, subjectivity, or other inherent risk factors. The auditor's consideration of the inherent risk factors may also provide information to be used in determining:

- Where inherent risk is assessed on the spectrum of inherent risk; and
- The reasons for the assessment given to the risks of material misstatement at the assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 are responsive to those reasons.

The interrelationships between the inherent risk factors are further explained in Appendix 1.

A67. The reasons for the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors. For example:

(a) Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.

(b) An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.

(c) Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

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40 HKSA 620, *Using the Work of an Auditor's Expert*

41 HKSA 330, paragraph 7(b)

A68. The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree and the auditor may identify fewer risks or assess inherent risk at the lower end of the spectrum of inherent risk.

A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree, and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates the auditor's application of professional skepticism may be particularly important.

A70. Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the assertion level,[42] regardless of the degree to which the accounting estimate was subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate, and therefore may assess inherent risk at the assertion level at the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level.

A71. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

Estimation Uncertainty (Ref: Para. 16(a))

A72. In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the auditor may consider:

- Whether the applicable financial reporting framework requires:
  - The use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs.
  - The use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that is unobservable and are therefore difficult for management to develop, or the use of various assumptions that are interrelated.
  - Disclosures about estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data that is not readily observable.

[42] HKSA 315 (Revised), paragraph 31

- Whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management:
  - To make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement); or
  - To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

A73. The size of the amount recognized or disclosed in the financial statements for an accounting estimate is not, in itself, an indicator of its susceptibility to misstatement because, for example, the accounting estimate may be understated.

A74. In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may preclude recognition of an item in the financial statements, or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A112–A113, A143–A144).

A75. In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. HKSA 570 (Revised)[43] establishes requirements and provides guidance in such circumstances.

Complexity or Subjectivity (Ref: Para. 16(b))

The Degree to Which Complexity Affects the Selection and Application of the Method

A76. In taking into account the degree to which the selection and application of the method used in making the accounting estimate are affected by complexity, the auditor may consider:

- The need for specialized skills or knowledge by management which may indicate that the method used to make an accounting estimate is inherently complex and therefore the accounting estimate may have a greater susceptibility to material misstatement. There may be a greater susceptibility to material misstatement when management has developed a model internally and has relatively little experience in doing so, or uses a model that applies a method that is not established or commonly used in a particular industry or environment.
- The nature of the measurement basis required by the applicable financial reporting framework, which may result in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them. For example, an expected credit loss provision may require judgments about future credit repayments and other cash flows, based on consideration of historical experience data and the application of forward looking assumptions. Similarly, the valuation of an insurance contract liability may require judgments about future insurance contract payments to be projected based on historical experience and current and assumed future trends.

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43 HKSA 570, (Revised), *Going Concern*

The Degree to Which Complexity Affects the Selection and Application of the Data

A77. In taking into account the degree to which the selection and application of the data used in making the accounting estimate are affected by complexity, the auditor may consider:

- The complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others. Also, for confidentiality or proprietary reasons, some external information sources will not (or not fully) disclose information that may be relevant in considering the reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed.
- The inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate.
- The need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret.

The Degree to Which Subjectivity Affects the Selection and Application of the Method, Assumptions or Data

A78. In taking into account the degree to which the selection and application of method, assumptions or data are affected by subjectivity, the auditor may consider:

- The degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques and factors to use in the estimation method.
- The uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing are a source of inherent estimation uncertainty, and give rise to the need for management judgment in selecting a point estimate, which in turn creates an opportunity for management bias. For example, an accounting estimate that incorporates forward looking assumptions may have a high degree of subjectivity which may be susceptible to management bias.

Other Inherent Risk Factors (Ref: Para. 16(b))

A79. The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is therefore misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

Significant Risks (Ref: Para. 17)

A80. The auditor's assessment of inherent risk, which takes into account the degree to which an accounting estimate is subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, assists the auditor in determining whether any of the risks of material misstatement identified and assessed are a significant risk.

Responses to the Assessed Risks of Material Misstatement

The Auditor's Further Audit Procedures (Ref: Para. 18)

A81. In designing and performing further audit procedures the auditor may use any of the three testing approaches (individually or in combination) listed in paragraph 18. For example, when several assumptions are used to make an accounting estimate, the auditor may decide to use a different testing approach for each assumption tested.

Obtaining Relevant Audit Evidence Whether Corroborative or Contradictory

A82. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.[44] Obtaining audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.

A83. HKSA 330 requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of the risk.[45] Therefore, the consideration of the nature or quantity of the audit evidence may be more important when inherent risks relating to an accounting estimate is assessed at the higher end of the spectrum of inherent risk.

Scalability

A84. The nature, timing and extent of the auditor's further audit procedures are affected by, for example:

- The assessed risks of material misstatement, which affect the persuasiveness of the audit evidence needed and influence the approach the auditor selects to audit an accounting estimate. For example, the assessed risks of material misstatement relating to the existence or valuation assertions may be lower for a straightforward accrual for bonuses that are paid to employees shortly after period end. In this situation, it may be more practical for the auditor to obtain sufficient appropriate audit evidence by evaluating events occurring up to the date of the auditor's report, rather than through other testing approaches.
- The reasons for the assessed risks of material misstatement.

When the Auditor Intends to Rely on the Operating Effectiveness of Relevant Controls (Ref: Para: 19)

A85. Testing the operating effectiveness of relevant controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity, and therefore requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

A86. In determining the nature, timing and extent of testing of the operating effectiveness of controls relating to accounting estimates, the auditor may consider factors such as:

- The nature, frequency and volume of transactions;
- The effectiveness of the design of the controls, including whether controls are appropriately designed to respond to the assessed inherent risk, and the strength of governance;
- The importance of particular controls to the overall control objectives and processes in place at the entity, including the sophistication of the information system to support transactions;
- The monitoring of controls and identified deficiencies in internal control;

[44] HKSA 500, paragraph A1

[45] HKSA 330, paragraphs 7(b) and A19

- The nature of the risks the controls are intended to address, for example, controls related to the exercise of judgment compared with controls over supporting data;
- The competency of those involved in the control activities;
- The frequency of performance of the control activities; and
- The evidence of performance of control activities.

Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence

A87. In some industries, such as the financial services industry, management makes extensive use of IT to conduct business. It may therefore be more likely that there are risks related to certain accounting estimates for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

A88. Circumstances when risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level may exist include:

- When controls are necessary to mitigate risks relating to the initiation, recording, processing, or reporting of information obtained from outside of the general and subsidiary ledgers.
- Information supporting one or more assertions is electronically initiated, recorded, processed, or reported. This is likely to be the case when there is a high volume of transactions or data, or a complex model is used, requiring the extensive use of information technology to ensure the accuracy and completeness of the information. A complex expected credit loss provision may be required for a financial institution or utility entity. For example, in the case of a utility entity, the data used in developing the expected credit loss provision may comprise many small balances resulting from a high volume of transactions. In these circumstances, the auditor may conclude that sufficient appropriate audit evidence cannot be obtained without testing controls around the model used to develop the expected credit loss provision.

In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over the accuracy and completeness of the information.

A89. As part of the audit of the financial statements for certain entities (such as a bank or insurer), the auditor also may be required by law or regulation to undertake additional procedures in relation to, or to provide an assurance conclusion on, internal control. In these and other similar circumstances, the auditor may be able to use information obtained in performing such procedures as audit evidence, subject to determining whether subsequent changes have occurred that may affect its relevance to the audit.

Significant Risks (Ref: Para. 20)

A90. When the auditor's further audit procedures in response to a significant risk consist only of substantive procedures, HKSA 330[46] requires that those procedures include tests of details. Such tests of details may be designed and performed under each of the approaches described in paragraph 18 of this HKSA based on the auditor's professional judgment in the circumstances. Examples of tests of details for significant risks related to accounting estimates include:

- Examination, for example, examining contracts to corroborate terms or assumptions.
- Recalculation, for example, verifying the mathematical accuracy of a model.
- Agreeing assumptions used to supporting documentation, such as third-party published information.

[46] HKSA 330, paragraph 21

Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor's Report (Ref: Para. 21)

A91. In some circumstances, obtaining audit evidence from events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence to address the risks of material misstatement. For example, sale of the complete inventory of a discontinued product shortly after the period end may provide sufficient appropriate audit evidence relating to the estimate of its net realizable value at the period end. In other cases, it may be necessary to use this testing approach in connection with another approach in paragraph 18.

A92. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide sufficient appropriate audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting estimate.

A93. Even if the auditor decides not to undertake this testing approach in respect of specific accounting estimates, the auditor is required to comply with HKSA 560. HKSA 560 requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified[47] and appropriately reflected in the financial statements.[48] Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under HKSA 560 is particularly relevant.

Testing How Management Made the Accounting Estimate (Ref. Para. 22)

A94. Testing how management made the accounting estimate may be an appropriate approach when, for example:

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is appropriate.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.
- The applicable financial reporting framework specifies how management is expected to make the accounting estimate. For example, this may be the case for an expected credit loss provision.
- The accounting estimate is derived from the routine processing of data.

Testing how management made the accounting estimate may also be an appropriate approach when neither of the other testing approaches is practical to perform, or may be an appropriate approach in combination with one of the other testing approaches.

Changes in Methods, Significant Assumptions and the Data from Prior Periods (Ref: Para. 23(a), 24(a), 25(a))

A95. When a change from prior periods in a method, significant assumption, or the data is not based on new circumstances or new information, or when significant assumptions are inconsistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, the auditor may need to have further discussions with management about the circumstances and, in doing so, challenge management regarding the appropriateness of the assumptions used.

47 HKSA 560, paragraph 6

48 HKSA 560, paragraph 8

Indicators of Management Bias (Ref: Para. 23(b), 24(b), 25(b))

A96. When the auditor identifies indicators of possible management bias, the auditor may need a further discussion with management and may need to reconsider whether sufficient appropriate audit evidence has been obtained that the method, assumptions and data used were appropriate and supportable in the circumstances. An example of an indicator of management bias for a particular accounting estimate may be when management has developed an appropriate range for several different assumptions, and in each case the assumption used was from the end of the range that resulted in the most favorable measurement outcome.

Methods

The selection of the method (Ref: Para. 23(a))

A97. Relevant considerations for the auditor regarding the appropriateness of the method selected in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Whether management's rationale for the method selected is appropriate;
- Whether the method is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, other available valuation concepts or techniques, regulatory requirements, and the business, industry and environment in which the entity operates;
- When management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences; and
- Whether the change is based on new circumstances or new information. When this is not the case, the change may not be reasonable or in compliance with the applicable financial reporting framework. Arbitrary changes result in inconsistent financial statements over time and may give rise to financial statement misstatements or may be an indicator of possible management bias. (see also paragraphs A133–A136)

These matters are important when the applicable financial reporting framework does not prescribe the method of measurement or allows multiple methods.

Complex modelling (Ref: Para. 23(d))

A98. A model, and the related method, is more likely to be complex when:

- Understanding and applying the method, including designing the model and selecting and using appropriate data and assumptions, requires specialized skills or knowledge;
- It is difficult to obtain data needed for use in the model because there are restrictions on the availability or observability of, or access to, data; or
- It is difficult to maintain the integrity (e.g., accuracy, consistency, or completeness) of the data and assumptions in using the model due to multiple valuation attributes, multiple relationships between them, or multiple iterations of the calculation.

A99. Matters that the auditor may consider when management uses a complex model include, for example, whether:

- The model is validated prior to usage or when there has been a change to the model, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
  - The model's theoretical soundness;
  - The model's mathematical integrity;
  - The accuracy and completeness of the model's data and assumptions; and
  - The model's output as compared to actual transactions.

- Appropriate change control policies and procedures exist.
- Management uses appropriate skills and knowledge in using the model.

These considerations may also be useful for a method that does not involve complex modelling.

A100. Management may make adjustments to the output of the model to meet the requirements of the applicable financial reporting framework. In some industries these adjustments are referred to as overlays. In the case of fair value accounting estimates, it may be relevant to consider whether adjustments to the output of the model, if any, reflect the assumptions marketplace participants would use in similar circumstances.

Maintenance of integrity of significant assumptions and the data used in applying the method (Ref: Para. 23(e))

A101. Maintaining the integrity of significant assumptions and the data in applying the method refers to the maintenance of the accuracy and completeness of the data and assumptions through all stages of information processing. A failure to maintain such integrity may result in corruption of the data and assumptions and may give rise to misstatements. In this regard, relevant considerations for the auditor may include whether the data and assumptions are subject to all changes intended by management, and not subject to any unintended changes, during activities such as input, storage, retrieval, transmission or processing.

Significant Assumptions (Ref: Para. 24)

A102. Relevant considerations for the auditor regarding the appropriateness of the significant assumptions in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Management's rationale for the selection of the assumption;
- Whether the assumption is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates; and
- Whether a change from prior periods in selecting an assumption is based on new circumstances or new information. When it is not, the change may not be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate may give rise to material misstatements of the financial statements or may be an indicator of possible management bias (see paragraphs A133–A136).

A103. Management may evaluate alternative assumptions or outcomes of accounting estimates, which may be accomplished through a number of approaches depending on the circumstances. One possible approach is a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there may be variation because different market participants will use different assumptions. A sensitivity analysis may lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, and including 'pessimistic' and 'optimistic' scenarios.

A104. Through the knowledge obtained in performing the audit, the auditor may become aware of or may have obtained an understanding of assumptions used in other areas of the entity's business. Such matters may include, for example, business prospects, assumptions in strategy documents and future cash flows. Also, if the engagement partner has performed other engagements for the entity, HKSA 315 (Revised)[49] requires the engagement partner to consider whether information obtained from those other engagements is relevant to identifying risks of material misstatement. This information may also be useful to consider in addressing whether significant assumptions are consistent with each other and with those used in other accounting estimates.

[49] HKSA 315 (Revised), paragraph 8

A105. The appropriateness of the significant assumptions in the context of the requirements of the applicable financial reporting framework may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the applicable financial reporting framework may require management to do so. The nature and extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment. When applicable, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Inspection of written plans and other documentation, including, when applicable, formally approved budgets, authorizations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments and legal, regulatory, or contractual restrictions that could affect the feasibility of management's actions.
- Consideration of whether management has met the applicable documentation requirements, if any, of the applicable financial reporting framework.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that significant assumptions reflect those used by marketplace participants.

Data (Ref: Para. 25(a))

A106. Relevant considerations for the auditor regarding the appropriateness of the data selected for use in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of the changes from the prior period may include:

- Management's rationale for the selection of the data;
- Whether the data is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates; and
- Whether the change from prior periods in the sources or items of data selected or data selected, is based on new circumstances or new information. When it is not, it is unlikely to be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to financial statement misstatements or may be an indicator of possible management bias (see paragraphs A133–A136).

Relevance and reliability of the data (Ref: Para. 25(c))

A107. When using information produced by the entity, HKSA 500 requires the auditor to evaluate whether the information is sufficiently reliable for the auditor's purposes, including as necessary in the circumstances, to obtain audit evidence about the accuracy and completeness of the information and evaluating whether the information is sufficiently precise and detailed for the auditor's purposes.[50]

Complex legal or contractual terms (Ref: Para. 25(d))

A108. Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include:

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[50] HKSA 500, paragraph 9

- Considering whether specialized skills or knowledge are needed to understand or interpret the contract;
- Inquiring of the entity's legal counsel regarding the legal or contractual terms; and
- Inspecting the underlying contracts to:
  - Evaluate, the underlying business purpose for the transaction or agreement; and
  - Consider whether the terms of the contracts are consistent with management's explanations.

Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty

Management's steps to understand and address estimation uncertainty (Ref: Para. 26(a))

A109. Relevant considerations regarding whether management has taken appropriate steps to understand and address estimation uncertainty may include whether management has:

(a) Understood the estimation uncertainty, through identifying the sources, and assessing the degree of inherent variability in the measurement outcomes and the resulting range of reasonably possible measurement outcomes;

(b) Identified the degree to which, in the measurement process, complexity or subjectivity affect the risk of material misstatement, and addressed the resulting potential for misstatement through applying:

(i) Appropriate skills and knowledge in making accounting estimates; and

(ii) Professional judgment, including by identifying and addressing susceptibility to management bias; and

(c) Addressed estimation uncertainty through appropriately selecting management's point estimate and related disclosures that describe the estimation uncertainty.

The selection of management's point estimate and related disclosures of estimation uncertainty (Ref: Para. 26(b))

A110. Matters that may be relevant regarding the selection of management's point estimate and the development of related disclosures about estimation uncertainty include whether:

- The methods and data used were selected appropriately, including when alternative methods for making the accounting estimate and alternative sources of data were available.
- Valuation attributes used were appropriate and complete.
- The assumptions used were selected from a range of reasonably possible amounts and were supported by appropriate data that is relevant and reliable.
- The data used was appropriate, relevant and reliable, and the integrity of that data was maintained.
- The calculations were applied in accordance with the method and were mathematically accurate.
- Management's point estimate is appropriately chosen from the reasonably possible measurement outcomes.
- The related disclosures appropriately describe the amount as an estimate and explain the nature and limitations of the estimation process, including the variability of the reasonably possible measurement outcomes.

A111. Relevant considerations for the auditor regarding the appropriateness of management's point estimate, may include:

- When the requirements of the applicable financial reporting framework prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribes a specific measurement method, whether management has followed the requirements of the applicable financial reporting framework.

- When the applicable financial reporting framework has not specified how to select an amount from reasonably possible measurement outcomes, whether management has exercised judgment, taking into account the requirements of the applicable financial reporting framework.

A112. Relevant considerations for the auditor regarding management's disclosures about estimation uncertainty include the requirements of the applicable financial reporting framework, which may require disclosures:

- That describe the amount as an estimate and explain the nature and limitations of the process for making it, including the variability in reasonably possible measurement outcomes. The framework also may require additional disclosures to meet a disclosure objective.[51]
- About significant accounting policies related to accounting estimates. Depending on the circumstances, relevant accounting policies may include matters such as the specific principles, bases, conventions, rules and practices applied in preparing and presenting accounting estimates in the financial statements.
- About significant or critical judgments (for example, those that had the most significant effect on the amounts recognized in the financial statements) as well as significant forward-looking assumptions or other sources of estimation uncertainty.

In certain circumstances, additional disclosures beyond those explicitly required by the financial reporting framework may be needed in order to achieve fair presentation, or in the case of a compliance framework, for the financial statements not to be misleading.

A113. The greater the degree to which an accounting estimate is subject to estimation uncertainty, the more likely the risks of material misstatement will be assessed as higher and therefore the more persuasive the audit evidence needs to be to determine, in accordance with paragraph 35, whether management's point estimate and related disclosures about estimation uncertainty are reasonable in the context of the applicable financial reporting framework, or are misstated.

A114. If the auditor's consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter.[52]

When Management Has Not Taken Appropriate Steps to Understand and Address Estimation Uncertainty (Ref: Para. 27)

A115. When the auditor determines that management has not taken appropriate steps to understand and address estimation uncertainty, additional procedures that the auditor may request management to perform to understand estimation uncertainty may include, for example, consideration of alternative assumptions or the performance of a sensitivity analysis.

A116. In considering whether it is practicable to develop a point estimate or range, matters the auditor may need to take into account include whether the auditor could do so without compromising independence requirements. This may include relevant ethical requirements that address prohibitions on assuming management responsibilities.

A117. If, after considering management's response, the auditor determines that it is not practicable to develop an auditor's point estimate or range, the auditor is required to evaluate the implications for the audit or the auditor's opinion on the financial statements in accordance with paragraph 34.

[51] HKFRS 13, *Fair Value Measurement*, paragraph 92

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

Developing an Auditor's Point Estimate or Using an Auditor's Range (Ref: Para. 28–29)

A118. Developing an auditor's point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty may be an appropriate approach when, for example:

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is not expected to be effective.
- The entity's controls within and over management's process for making accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report have not been properly taken into account, when it is appropriate for management to do so, and such events or transactions appear to contradict management's point estimate.
- There are appropriate alternative assumptions or sources of relevant data that can be used in developing an auditor's point estimate or a range.
- Management has not taken appropriate steps to understand or address the estimation uncertainty (see paragraph 27).

A119. The decision to develop a point estimate or range also may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value, or the most likely outcome).

A120. The auditor's decision as to whether to develop a point estimate rather than a range may depend on the nature of the estimate and the auditor's judgment in the circumstances. For example, the nature of the estimate may be such that there is expected to be less variability in the reasonably possible outcomes. In these circumstances, developing a point estimate may be an effective approach, particularly when it can be developed with a higher degree of precision.

A121. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a different model than the one used by management, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Using management's model but developing alternative assumptions or data sources to those used by management.
- Using the auditor's own method but developing alternative assumptions to those used by management.
- Employing or engaging a person with specialized expertise to develop or execute a model, or to provide relevant assumptions.
- Consideration of other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

A122. The auditor also may develop a point estimate or range for only part of the accounting estimate (for example, for a particular assumption, or when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).

A123. When using the auditor's own methods, assumptions or data to develop a point estimate or range, the auditor may obtain evidence about the appropriateness of management's methods, assumptions or data. For example, if the auditor uses the auditor's own assumptions in developing a range to evaluate the reasonableness of management's point estimate, the auditor may also develop a view about whether management's judgments in selecting the significant assumptions used in making the accounting estimate give rise to indicators of possible management bias.

A124. The requirement in paragraph 29(a) for the auditor to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence does not mean that the auditor is expected to obtain audit evidence to support each possible outcome in the range individually. Rather, the auditor is likely to obtain evidence to determine that the points at both ends of the range are reasonable in the circumstances, thereby supporting that amounts falling between those two points also are reasonable.

A125. The size of the auditor's range may be multiples of materiality for the financial statements as a whole, particularly when materiality is based on operating results (for example, pre-tax income) and this measure is relatively small in relation to assets or other balance sheet measures. This situation is more likely to arise in circumstances when the estimation uncertainty associated with the accounting estimate is itself multiples of materiality, which is more common for certain types of accounting estimates or in certain industries, such as insurance or banking, where a high degree of estimation uncertainty is more typical and there may be specific requirements in the applicable financial reporting framework in that regard. Based on the procedures performed and audit evidence obtained in accordance with the requirements of this HKSA, the auditor may conclude that a range that is multiples of materiality is, in the auditor's judgment, appropriate in the circumstances. When this is the case, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly important, particularly whether such disclosures appropriately convey the high degree of estimation uncertainty and the range of possible outcomes. Paragraphs A139–A144 include additional considerations that may be relevant in these circumstances.

Other Considerations Relating to Audit Evidence (Ref: Para. 30)

A126. Information to be used as audit evidence, regarding risks of material misstatement relating to accounting estimates, may have been produced by the entity, prepared using the work of a management's expert, or provided by an external information source.

External Information Sources

A127. As explained in HKSA 500,[53] the reliability of information from an external information source is influenced by its source, its nature, and the circumstances under which it is obtained. Consequently, the nature and extent of the auditor's further audit procedures to consider the reliability of the information used in making an accounting estimate may vary depending on the nature of these factors. For example:

- When market or industry data, prices, or pricing related data, are obtained from a single external information source, specializing in such information, the auditor may seek a price from an alternative independent source with which to compare.
- When market or industry data, prices, or pricing related data, are obtained from multiple independent external information sources and points to consensus across those sources, the auditor may need to obtain less evidence about the reliability of the data from an individual source.
- When information obtained from multiple information sources points to divergent market views the auditor may seek to understand the reasons for the diversity in views. The diversity may result from the use of different methods, assumptions, or data. For example, one source may be using current prices and another source using future prices. When the diversity relates to estimation uncertainty, the auditor is required by paragraph 26(b) to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, the disclosures in the financial statements that describe the estimation uncertainty are reasonable. In such cases professional judgment is also important in considering information about the methods, assumptions or data applied.
- When information obtained from an external information source has been developed by that source using its own model(s). Paragraph A33f of HKSA 500 provides relevant guidance.

53 HKSA 500, Paragraph A31

A128. For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include:

(a) Whether fair values are based on trades of the same instrument or active market quotations;

(b) When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;

(c) When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and

(d) When the fair value measurement is based on a broker quote, whether the broker quote:

(i) Is from a market maker who transacts in the same type of financial instrument;

(ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and

(iii) Reflects market conditions as of the date of the financial statements, when required by the applicable financial reporting framework.

A129. When information from an external information source is used as audit evidence, a relevant consideration for the auditor may be whether information can be obtained, or whether the information is sufficiently detailed, to understand the methods, assumptions and other data used by the external information source. This may be limited in some respects and consequently influence the auditor's consideration of the nature, timing and extent of procedures to perform. For example, pricing services often provide information about their methods and assumptions by asset class rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker indicative quotes for individual securities. Paragraph A33g of HKSA 500 provides guidance with respect to restrictions placed by the external information source on the provision of supporting information.

Management's Expert

A130. Assumptions relating to accounting estimates that are made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate. Accordingly, the auditor applies the relevant requirements in this HKSA to those assumptions.

A131. If the work of a management's expert involves the use of methods or sources of data relating to accounting estimates, or developing or providing findings or conclusions relating to a point estimate or related disclosures for inclusion in the financial statements, the requirements in paragraphs 21–29 of this HKSA may assist the auditor in applying paragraph 8(c) of HKSA 500.

Service Organizations

A132. HKSA 402[54] deals with the auditor's understanding of the services provided by a service organization, including internal control, as well as the auditor's responses to assessed risks of material misstatement. When the entity uses the services of a service organization in making accounting estimates, the requirements and guidance in HKSA 402 may therefore assist the auditor in applying the requirements of this HKSA.

54 HKSA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

Indicators of Possible Management Bias (Ref: Para. 32)

A133. Management bias may be difficult to detect at an account level and may only be identified by the auditor when considering groups of accounting estimates, all accounting estimates in aggregate, or when observed over a number of accounting periods. For example, if accounting estimates included in the financial statements are considered to be individually reasonable but management's point estimates consistently trend toward one end of the auditor's range of reasonable outcomes that provide a more favorable financial reporting outcome for management, such circumstances may indicate possible bias by management.

A134. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances.
- Selection or development of significant assumptions or the data that yield a point estimate favorable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

When such indicators are identified, there may be a risk of material misstatement either at the assertion or financial statement level. Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. However, in some cases the audit evidence may point to a misstatement rather than simply an indicator of management bias.

A135. Indicators of possible management bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate. The auditor may also need to consider the implications for other aspects of the audit, including the need to further question the appropriateness of management's judgments in making accounting estimates. Further, indicators of possible management bias may affect the auditor's conclusion as to whether the financial statements as a whole are free from material misstatement, as discussed in HKSA 700 (Revised).[55]

A136. In addition, in applying HKSA 240, the auditor is required to evaluate whether management's judgments and decisions in making the accounting estimates included in the financial statements indicate a possible bias that may represent a material misstatement due to fraud.[56] Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting estimates. Indicators of possible management bias that may also be a fraud risk factor, may cause the auditor to reassess whether the auditor's risk assessments, in particular the assessment of fraud risks, and related responses remain appropriate.

Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 33)

A137. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures.[57] In relation to accounting estimates, information may come to the auditor's attention through performing procedures to obtain audit evidence that differs significantly from the information on which the risk assessment was based. For example, the auditor may have identified that the only reason for an assessed risk of material misstatement is the subjectivity involved in making the accounting estimate. However, while performing procedures to respond to the assessed risks of material misstatement, the auditor may discover that the accounting estimate is more complex than originally contemplated, which may call into question the assessment of the risk of material misstatement (for example, the inherent risk may need to be re-assessed on the higher end of the spectrum of inherent risk due to the effect of complexity) and therefore the

[55] HKSA 700 (Revised), paragraph 11

[56] HKSA 240, paragraph 32(b)

[57] HKSA 330, paragraph A60

auditor may need to perform additional further audit procedures to obtain sufficient appropriate audit evidence.[58]

A138. With respect to accounting estimates that have not been recognized, a particular focus of the auditor's evaluation may be on whether the recognition criteria of the applicable financial reporting framework have in fact been met. When an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial statements.

Determining Whether the Accounting Estimates are Reasonable or Misstated (Ref: Para. 9, 35)

A139. In determining whether, based on the audit procedures performed and evidence obtained, management's point estimate and related disclosures are reasonable, or are misstated:

- When the audit evidence supports a range, the size of the range may be wide and, in some circumstances, may be multiples of materiality for the financial statements as a whole (see also paragraph A125). Although a wide range may be appropriate in the circumstances, it may indicate that it is important for the auditor to reconsider whether sufficient appropriate audit evidence has been obtained regarding the reasonableness of the amounts within the range.
- The audit evidence may support a point estimate that differs from management's point estimate. In such circumstances, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.
- The audit evidence may support a range that does not include management's point estimate. In such circumstances, the misstatement is the difference between management's point estimate and the nearest point of the auditor's range.

A140. Paragraphs A110–A114 provide guidance to assist the auditor in evaluating management's selection of a point estimate and related disclosures to be included in the financial statements.

A141. When the auditor's further audit procedures include testing how management made the accounting estimate or developing an auditor's point estimate or range, the auditor is required to obtain sufficient appropriate audit evidence about disclosures that describe estimation uncertainty in accordance with paragraphs 26(b) and 29(b) and other disclosures in accordance with paragraph 31. The auditor then considers the audit evidence obtained about disclosures as part of the overall evaluation, in accordance with paragraph 35, of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

A142. HKSA 450 also provides guidance regarding qualitative disclosures[59] and when misstatements in disclosures could be indicative of fraud.[60]

A143. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation[61] includes the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the transactions and events in a manner that achieves fair presentation. For example, when an accounting estimate is subject to a higher degree of estimation uncertainty, the auditor may determine that additional disclosures are necessary to achieve fair presentation. If management does not include such additional disclosures, the auditor may conclude that the financial statements are materially misstated.

A144. HKSA 705 (Revised)[62] provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosures in the financial statements are inadequate or misleading, including, for example, with respect to estimation uncertainty.

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[58] See also HKSA 315 (Revised), paragraph 31.

[59] HKSA 450, paragraph A17

[60] HKSA 450, paragraph A22

[61] HKSA 700 (Revised), paragraph 14

[62] HKSA 705 (Revised), paragraphs 22–23

Written Representations (Ref: Para. 37)

A145. Written representations about specific accounting estimates may include representations:

- That the significant judgments made in making the accounting estimates have taken into account all relevant information of which management is aware.
- About the consistency and appropriateness in the selection or application of the methods, assumptions and data used by management in making the accounting estimates.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, when relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates, including disclosures describing estimation uncertainty, are complete and are reasonable in the context of the applicable financial reporting framework.
- That appropriate specialized skills or expertise has been applied in making the accounting estimates.
- That no subsequent event requires adjustment to the accounting estimates and related disclosures included in the financial statements.
- When accounting estimates are not recognized or disclosed in the financial statements, about the appropriateness of management's decision that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.

Communication with Those Charged With Governance, Management or Other Relevant Parties (Ref: Para. 38)

A146. In applying HKSA 260 (Revised), the auditor communicates with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices relating to accounting estimates and related disclosures.[63] Appendix 2 includes matters specific to accounting estimates that the auditor may consider communicating to those charged with governance.

A147. HKSA 265 requires the auditor to communicate in writing to those charged with governance significant deficiencies in internal control identified during the audit.[64] Such significant deficiencies may include those related to controls over:

(a) The selection and application of significant accounting policies, and the selection and application of methods, assumptions and data;

(b) Risk management and related systems;

(c) Data integrity, including when data is obtained from an external information source; and

(d) The use, development and validation of models, including models obtained from an external provider, and any adjustments that may be required.

A148. In addition to communicating with those charged with governance, the auditor may be permitted or required to communicate directly with regulators or prudential supervisors. Such communication may be useful throughout the audit or at particular stages, such as when planning the audit or when finalizing the auditor's report. For example, in some jurisdictions, financial institution regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, expected credit losses, and insurance reserves while other regulators may seek to understand the auditor's views on significant aspects of the entity's operations including the entity's costs estimates. This communication may be helpful to the auditor in identifying, assessing and responding to risks of material misstatement.

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63 HKSA 260 (Revised), paragraph 16(a)

64 HKSA 265, paragraph 9

Documentation (Ref: Para. 39)

A149. HKSA 315 (Revised)[65] and HKSA 330[66] provide requirements and guidance on documenting the auditor's understanding of the entity, risk assessments and responses to assessed risks. This guidance is based on the requirements and guidance in HKSA 230.[67] In the context of auditing accounting estimates, the auditor is required to prepare audit documentation about key elements of the auditor's understanding of the entity and its environment related to accounting estimates. In addition, the auditor's judgments about the assessed risks of material misstatement related to accounting estimates, and the auditor's responses, may likely be further supported by documentation of communications with those charged with governance and management.

A150. In documenting the linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, in accordance with HKSA 330, this HKSA requires that the auditor take into account the reasons given to the risks of material misstatement at the assertion level. Those reasons may relate to one or more inherent risk factors or the auditor's assessment of control risk. However, the auditor is not required to document how every inherent risk factor was taken into account in identifying and assessing the risks of material misstatement in relation to each accounting estimate.

A151. The auditor also may consider documenting:

- When management's application of the method involves complex modeling, whether management's judgments have been applied consistently and, when applicable, that the design of the model meets the measurement objective of the applicable financial reporting framework.
- When the selection and application of methods, significant assumptions, or the data is affected by complexity to a higher degree, the auditor's judgments in determining whether specialized skills or knowledge are required to perform the risk assessment procedures, to design and perform procedures responsive to those risks, or to evaluate the audit evidence obtained. In these circumstances, the documentation also may include how the required skills or knowledge were applied.

A152. Paragraph A7 of HKSA 230 notes that, although there may be no single way in which the auditor's exercise of professional skepticism is documented, the audit documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained. Examples of other requirements in this HKSA for which documentation may provide evidence of the exercise of professional skepticism by the auditor include:

- Paragraph 13(d), regarding how the auditor has applied an understanding in developing the auditor's own expectation of the accounting estimates and related disclosures to be included in the entity's financial statements and how that expectation compares with the entity's financial statements prepared by management;
- Paragraph 18, which requires further audit procedures to be designed and performed to obtain sufficient appropriate evidence in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory;
- Paragraphs 23(b), 24(b), 25(b) and 32, which address indicators of possible management bias; and

[65] HKSA 315 (Revised), paragraphs 32 and A153–A156

[66] HKSA 330, paragraphs 28 and A63

[67] HKSA 230, paragraph 8(c)

- Paragraph 34, which addresses the auditor's consideration of all relevant audit evidence, whether corroborative or contradictory.

Appendix 1

(Ref: Para. 2, 4, 12(c), A8, A66)

Inherent Risk Factors

Introduction

1. In identifying, assessing and responding to the risks of material misstatement at the assertion level for an accounting estimate and related disclosures, this HKSA requires the auditor to take into account the degree to which the accounting estimate is subject to estimation uncertainty, and the degree to which the selection and application of the methods, assumptions and data used in making the accounting estimate, and the selection of management's point estimate and related disclosures for inclusion in the financial statements, are affected by complexity, subjectivity or other inherent risk factors.

2. Inherent risk related to an accounting estimate is the susceptibility of an assertion about the accounting estimate to material misstatement, before consideration of controls. Inherent risk results from inherent risk factors, which give rise to challenges in appropriately making the accounting estimate. This Appendix provides further explanation about the nature of the inherent risk factors of estimation uncertainty, subjectivity and complexity, and their inter-relationships, in the context of making accounting estimates and selecting management's point estimate and related disclosures for inclusion in the financial statements.

Measurement Basis

3. The measurement basis and the nature, condition and circumstances of the financial statement item give rise to relevant valuation attributes. When the cost or price of the item cannot be directly observed, an accounting estimate is required to be made by applying an appropriate method and using appropriate data and assumptions. The method may be specified by the applicable financial reporting framework, or is selected by management, to reflect the available knowledge about how the relevant valuation attributes would be expected to influence the cost or price of the item on the measurement basis.

Estimation Uncertainty

4. Susceptibility to a lack of precision in measurement is often referred to in accounting frameworks as measurement uncertainty. Estimation uncertainty is defined in this HKSA as susceptibility to an inherent lack of precision in measurement. It arises when the required monetary amount for a financial statement item that is recognized or disclosed in the financial statements cannot be measured with precision through direct observation of the cost or price. When direct observation is not possible, the next most precise alternative measurement strategy is to apply a method that reflects the available knowledge about cost or price for the item on the relevant measurement basis, using observable data about relevant valuation attributes.

5. However, constraints on the availability of such knowledge or data may limit the verifiability of such inputs to the measurement process and therefore limit the precision of measurement outcomes. Furthermore, most accounting frameworks acknowledge that there are practical constraints on the information that should be taken into account, such as when the cost of obtaining it would exceed the benefits. The lack of precision in measurement arising from these constraints is inherent because it cannot be eliminated from the measurement process. Accordingly, such constraints are sources of estimation uncertainty. Other sources of measurement uncertainty that may occur in the measurement process are, at least in principle, capable of elimination if the method is applied appropriately and therefore are sources of potential misstatement rather than estimation uncertainty.

6. When estimation uncertainty relates to uncertain future inflows or outflows of economic benefits that will ultimately result from the underlying asset or liability, the outcome of these flows will only be observable after the date of the financial statements. Depending on the nature of the applicable measurement basis and on the nature, condition and circumstances of the financial statement item, this outcome may be directly observable before the financial statements are finalized or may only be directly observable at a later date. For some accounting estimates, there may be no directly observable outcome at all.

7. Some uncertain outcomes may be relatively easy to predict with a high level of precision for an individual item. For example, the useful life of a production machine may be easily predicted if sufficient technical information is available about its average useful life. When it is not possible to predict a future outcome, such as an individual's life expectancy based on actuarial assumptions, with reasonable precision, it may still be possible to predict that outcome for a group of individuals with greater precision. Measurement bases may, in some cases, indicate a portfolio level as the relevant unit of account for measurement purposes, which may reduce inherent estimation uncertainty.

Complexity

8. Complexity (i.e., the complexity inherent in the process of making an accounting estimate, before consideration of controls) gives rise to inherent risk. Inherent complexity may arise when:

   - There are many valuation attributes with many or non-linear relationships between them.
   - Determining appropriate values for one or more valuation attributes requires multiple data sets.
   - More assumptions are required in making the accounting estimate, or when there are correlations between the required assumptions.
   - The data used is inherently difficult to identify, capture, access or understand.

9. Complexity may be related to the complexity of the method and of the computational process or model used to apply it. For example, complexity in the model may reflect the need to apply probability-based valuation concepts or techniques, option pricing formulae or simulation techniques to predict uncertain future outcomes or hypothetical behaviors. Similarly, the computational process may require data from multiple sources, or multiple data sets to support the making of an assumption or the application of sophisticated mathematical or statistical concepts.

10. The greater the complexity, the more likely it is that management will need to apply specialized skills or knowledge in making an accounting estimate or engage a management's expert, for example in relation to:

    - Valuation concepts and techniques that could be used in the context of the measurement basis and objectives or other requirements of the applicable financial reporting framework and how to apply those concepts or techniques;
    - The underlying valuation attributes that may be relevant given the nature of the measurement basis and the nature, condition and circumstances of the financial statement items for which accounting estimates are being made; or
    - Identifying appropriate sources of data from internal sources (including from sources outside the general or subsidiary ledgers) or from external information sources, determining how to address potential difficulties in obtaining data from such sources or in maintaining its integrity in applying the method, or understanding the relevance and reliability of that data.

11. Complexity relating to data may arise, for example, in the following circumstances:

    (a) When data is difficult to obtain or when it relates to transactions that are not generally accessible. Even when such data is accessible, for example through an external information source, it may be difficult to consider the relevance and reliability of the data, unless the external information source discloses adequate information about the underlying data sources it has used and about any data processing that has been performed.

(b) When data reflecting an external information source's views about future conditions or events, which may be relevant in developing support for an assumption, is difficult to understand without transparency about the rationale and information taken into account in developing those views.

(c) When certain types of data are inherently difficult to understand because they require an understanding of technically complex business or legal concepts, such as may be required to properly understand data that comprises the terms of legal agreements about transactions involving complex financial instruments or insurance products.

Subjectivity

12. Subjectivity (i.e., the subjectivity inherent in the process of making an accounting estimate, before consideration of controls) reflects inherent limitations in the knowledge or data reasonably available about valuation attributes. When such limitations exist, the applicable financial reporting framework may reduce the degree of subjectivity by providing a required basis for making certain judgments. Such requirements may, for example, set explicit or implied objectives relating to measurement, disclosure, the unit of account, or the application of a cost constraint. The applicable financial reporting framework may also highlight the importance of such judgments through requirements for disclosures about those judgments.

13. Management judgment is generally needed in determining some or all of the following matters, which often involve subjectivity:

- To the extent not specified under the requirements of the applicable financial reporting framework, the appropriate valuation approaches, concepts, techniques and factors to use in the estimation method, having regard to available knowledge;
- To the extent valuation attributes are observable when there are various potential sources of data, the appropriate sources of data to use;
- To the extent valuation attributes are not observable, the appropriate assumptions or range of assumptions to make, having regard to the best available data, including, for example, market views;
- The range of reasonably possible outcomes from which to select management's point estimate, and the relative likelihood that certain points within that range would be consistent with the objectives of the measurement basis required by the applicable financial reporting framework; and
- The selection of management's point estimate, and the related disclosures to be made, in the financial statements.

14. Making assumptions about future events or conditions involves the use of judgment, the difficulty of which varies with the degree to which those events or conditions are uncertain. The precision with which it is possible to predict uncertain future events or conditions depends on the degree to which those events or conditions are determinable based on knowledge, including knowledge of past conditions, events and related outcomes. The lack of precision also contributes to estimation uncertainty, as described above.

15. With respect to future outcomes, assumptions will only need to be made for those features of the outcome that are uncertain. For example, in considering the measurement of a possible impairment of a receivable for a sale of goods at the balance sheet date, the amount of the receivable may be unequivocally established and directly observable in the related transaction documents. What may be uncertain is the amount, if any, for loss due to impairment. In this case, assumptions may only be required about the likelihood of loss and about the amount and timing of any such loss.

16. However, in other cases, the amounts of cash flows embodied in the rights relating to an asset may be uncertain. In those cases, assumptions may have to be made about both the amounts of the underlying rights to cash flows and about potential losses due to impairment.

17. It may be necessary for management to consider information about past conditions and events, together with current trends and expectations about future developments. Past conditions and events provide historical information that may highlight repeating historical patterns that can be extrapolated in evaluating future outcomes. Such historical information may also indicate changing patterns of such behavior over time (cycles or trends). These may suggest that the underlying historical patterns of behavior have been changing in somewhat predictable ways that may also be extrapolated in evaluating future outcomes. Other types of information may also be available that indicate possible changes in historical patterns of such behavior or in related cycles or trends. Difficult judgments may be needed about the predictive value of such information.

18. The extent and nature (including the degree of subjectivity involved) of the judgments taken in making the accounting estimates may create opportunity for management bias in making decisions about the course of action that, according to management, is appropriate in making the accounting estimate. When there is also a high level of complexity or a high level of estimation uncertainty, or both, the risk of, and opportunity for, management bias or fraud may also be increased.

Relationship of Estimation Uncertainty to Subjectivity and Complexity

19. Estimation uncertainty gives rise to inherent variation in the possible methods, data sources and assumptions that could be used to make an accounting estimate. This gives rise to subjectivity, and hence, the need for the use of judgment in making the accounting estimate. Such judgments are required in selecting the appropriate methods and data sources, in making the assumptions, and in selecting management's point estimate and related disclosures for inclusion in the financial statements. These judgments are made in the context of the recognition, measurement, presentation and disclosure requirements of the applicable financial reporting framework. However, because there are constraints on the availability and accessibility of knowledge or information to support these judgments, they are subjective in nature.

20. Subjectivity in such judgments creates the opportunity for unintentional or intentional management bias in making them. Many accounting frameworks require that information prepared for inclusion in the financial statements should be neutral (i.e., that it should not be biased). Given that bias can, at least in principle, be eliminated from the estimation process, sources of potential bias in the judgments made to address subjectivity are sources of potential misstatement rather than sources of estimation uncertainty.

21. The inherent variation in the possible methods, data sources and assumptions that could be used to make an accounting estimate (see paragraph 19) also gives rise to variation in the possible measurement outcomes. The size of the range of reasonably possible measurement outcomes results from the degree of estimation uncertainty and is often referred to as the sensitivity of the accounting estimate. In addition to determining measurement outcomes, an estimation process also involves analyzing the effect of inherent variations in the possible methods, data sources and assumptions on the range of reasonably possible measurement outcomes (referred to as sensitivity analysis).

22. Developing a financial statement presentation for an accounting estimate, which, when required by the applicable financial reporting framework, achieves faithful representation (i.e., complete, neutral and free from error) includes making appropriate judgments in selecting a management point estimate that is appropriately chosen from within the range of reasonably possible measurement outcomes and related disclosures that appropriately describe the estimation uncertainty. These judgments may themselves involve subjectivity, depending on the nature of the requirements in the applicable financial reporting framework that address these matters. For example, the applicable financial reporting framework may require a specific basis (such as a probability weighted average or a best estimate) for the selection of the management point estimate. Similarly, it may require specific disclosures or disclosures that meet specified disclosure objectives or additional disclosures that are required to achieve fair presentation in the circumstances.

23. Although an accounting estimate that is subject to a higher degree of estimation uncertainty may be less precisely measurable than one subject to a lower degree of estimation uncertainty, the accounting estimate may still have sufficient relevance for users of the financial statements to be recognized in the financial statements if, when required by the applicable financial reporting framework, a faithful representation of the item can be achieved. In some cases, estimation uncertainty may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be recognized in the financial statements. Even in these circumstances, there may still be relevant disclosure requirements, for example to disclose the point estimate or range of reasonably possible measurement outcomes and information describing the estimation uncertainty and constraints in recognizing the item. The requirements of the applicable financial reporting framework that apply in these circumstances may be specified to a greater or lesser degree. Accordingly, in these circumstances, there may be additional judgments that involve subjectivity to be made.

Appendix 2

(Ref: Para. A146)

Communications with Those Charged with Governance

Matters that the auditor may consider communicating with those charged with governance with respect to the auditor's views about significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures include:

(a) How management identifies transactions, other events and conditions that may give rise to the need for, or changes in, accounting estimates and related disclosures.

(b) Risks of material misstatement.

(c) The relative materiality of the accounting estimates to the financial statements as a whole;

(d) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates;

(e) Whether management has applied appropriate specialized skills or knowledge or engaged appropriate experts.

(f) The auditor's views about differences between the auditor's point estimate or range and management's point estimate.

(g) The auditor's views about the appropriateness of the selection of accounting policies related to accounting estimates and presentation of accounting estimates in the financial statements.

(h) Indicators of possible management bias.

(i) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates

(j) When there has been a change from the prior period in the methods for making the accounting estimate, why, as well as the outcome of accounting estimates in prior periods.

(k) Whether management's methods for making the accounting estimates, including when management has used a model, are appropriate in the context of the measurement objectives, the nature, conditions and circumstances, and other requirements of the applicable financial reporting framework.

(l) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions;

(m) Whether significant assumptions are consistent with each other and with those used in other accounting estimates, or with assumptions used in other areas of the entity's business activities.

(n) When relevant to the appropriateness of the significant assumptions or the appropriate application of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so.

(o) How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

(p) Whether the data and significant assumptions used by management in making the accounting estimates are appropriate in the context of the applicable financial reporting framework.

(q) The relevance and reliability of information obtained from an external information source.

(r) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to data obtained from an external information source or valuations performed by management or a management's expert.

(s) Significant differences in judgments between the auditor and management or a management's expert regarding valuations.

(t) The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the estimation uncertainty associated with accounting estimates.

(u) The reasonableness of disclosures about estimation uncertainty in the financial statements.

(v) Whether management's decisions relating to the recognition, measurement, presentation and disclosure of the accounting estimates and related disclosures in the financial statements are in accordance with the applicable financial reporting framework.

CONFORMING AND CONSEQUENTIAL AMENDMENTS TO OTHER HONG KONG STANDARDS

Note: The following are conforming amendments to other Hong Kong Standards as a result of the approval of HKSA 540 (Revised). These amendments will become effective at the same time as HKSA 540 (Revised), and are shown with marked changes from the latest approved versions of the Hong Kong Standards that are amended. The footnote numbers within these amendments do not align with the Hong Kong Standards that are amended, and reference should be made to those Hong Kong Standards.

HKSA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Hong Kong Standards on Auditing*

…

Application and Other Explanatory Material

…

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

…

Audit Risk

…

Risks of Material Misstatement

…

A42. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made. The HKSAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the "risks of material misstatement." However, HKSA 540 (Revised)[68] requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, for accounting estimates at the assertion level in accordance with HKSA 330.[69] In identifying and assessing risks of material misstatement for significant classes of transactions, account balances or disclosures other than accounting estimates, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. ~~The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.~~

…

[68] HKSA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures,* paragraph 16

[69] HKSA 330, paragraph 7(b)

HKSA 230, *Audit Documentation*

…

Requirements

…

Documentation of the Audit Procedures Performed and Audit Evidence Obtained

Form, Content and Extent of Audit Documentation

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

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

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

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

…

Application and Other Explanatory Material

…

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

…

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

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

- Similarly, that the engagement partner has taken responsibility for the direction, supervision and performance of the audit in compliance with the HKSAs may be evidenced in a number of ways within the audit documentation. This may include documentation of the engagement partner's timely involvement in aspects of the audit, such as participation in the team discussions required by HKSA 315 (Revised).[70]

…

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

…

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

- The rationale for the auditor's conclusion when a requirement provides that the auditor "shall consider" certain information or factors, and that consideration is significant in the context of the particular engagement.
- The basis for the auditor's conclusion on the reasonableness of areas of subjective judgments <u>made by management</u> ~~(for example, the reasonableness of significant accounting estimates)~~.
- <u>The basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.</u>
- The basis for the auditor's conclusions about the authenticity of a document when further investigation (such as making appropriate use of an expert or of confirmation procedures) is undertaken in response to conditions identified during the audit that caused the auditor to believe that the document may not be authentic.
- When HKSA 701 applies,[71] the auditor's determination of the key audit matters or the determination that there are no key audit matters to be communicated.

…

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

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

Appendix

(Ref: Para 1)

Specific Audit Documentation Requirements in Other HKSAs

…

- HKSA 540 (Revised), Auditing Accounting Estimates~~, Including Fair Value Accounting Estimates,~~ and Related Disclosures – paragraph 39~~23~~

…

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

…

Application and Other Explanatory Material

…

A47. A retrospective review is also required by HKSA 540 (Revised). That review is conducted as a risk assessment procedure to obtain information regarding the effectiveness of management's previous~~prior period estimation process~~ accounting estimates, audit evidence about the outcome, or where applicable, their subsequent re-estimation ~~of prior period accounting estimates that is pertinent to making~~to assist in identifying and assessing the risks of material misstatement in the current period ~~accounting estimates~~, and audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements. As a practical matter, the auditor's review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with this HKSA may be carried out in conjunction with the review required by HKSA 540 (Revised).

…

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

…

Requirements

…

Matters to Be Communicated

…

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)

    a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)

    b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)

    c) Unless all of those charged with governance are involved in managing the entity:

        (i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)

        (ii) Written representations the auditor is requesting;

    d) Circumstances that affect the form and content of the auditor's report, if any; and (Ref: Para. A23–A25)

    e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process. (Ref: Para. A26–A28)

…

Application and Other Explanatory Material

…

Matters to Be Communicated

…

Significant Findings from the Audit

…

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(a))

A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of ~~key~~ assumptions in the development of accounting estimates ~~for which there is significant measurement uncertainty~~. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.

A20. As a result, the auditor's views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's ~~evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks.~~ views on the degree to which complexity, subjectivity or other inherent risk factors affect the selection or application of the methods, assumptions and data used in making a significant accounting estimate, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework. Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices and on the quality of the disclosures. When applicable, this may include whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity, for example, when an alternative acceptable method for making an accounting estimate would, in the auditor's judgment, be more appropriate. Appendix 2 identifies matters that may be included in this communication.

…

Appendix 1

(Ref: Para. 3)

Specific Requirements in HKSQC 1 and Other HKSAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in HKSQC 1[72] and other HKSAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in HKSAs.

- HKSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* – paragraph 30(a)
- HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 21, 38(c)(i) and 40-42
- HKSA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 14, 19 and 22–24; HKSA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 15, 20 and 23-25
- HKSA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9
- HKSA 450, *Evaluation of Misstatements Identified during the Audit* – paragraphs 12-13
- HKSA 505, *External Confirmations* – paragraph 9
- HKSA 510, *Initial Audit Engagements—Opening Balances* – paragraph 7
- <u>HKSA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* – paragraph 38</u>
- HKSA 550, *Related Parties* – paragraph 27
- HKSA 560, *Subsequent Events* – paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17
- HKSA 570 (Revised), *Going Concern* – paragraph 25
- HKSA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* – paragraph 49
- HKSA 610 (Revised 2013), *Using the Work of Internal Auditors* – paragraphs 20 and 31
- HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* – paragraph 46
- HKSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* – paragraph 17
- HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* – paragraphs 12, 14, 23 and 30
- HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* – paragraph 12
- HKSA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraph 18
- HKSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* – paragraph 17—19

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

Appendix 2

(Ref: Para. 16(a), A19–A20)

Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

Accounting Policies

…

Accounting Estimates and Related Disclosures

~~For items for which estimates are significant, issues discussed in HKSA 540,[73] including, for example:~~ Appendix 2 of HKSA 540 (Revised) includes matters that the auditor may consider communicating with respect to significant qualitative aspects of the entity's accounting practices related to accounting estimates and related disclosures.

- ~~How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.~~
- ~~Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.~~
- ~~Whether management's decision to recognize, or to not recognize, the accounting estimates in the financial statements is in accordance with the applicable financial reporting framework.~~
- ~~Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why, as well as the outcome of accounting estimates in prior periods.~~
- ~~Management's process for making accounting estimates (e.g., when management has used a model), including whether the selected measurement basis for the accounting estimate is in accordance with the applicable financial reporting framework.~~
- ~~Whether the significant assumptions used by management in developing the accounting estimate are reasonable.~~
- ~~Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.~~
- ~~Risks of material misstatement.~~
- ~~Indicators of possible management bias.~~
- ~~How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.~~
- ~~The adequacy of disclosure of estimation uncertainty in the financial statements.~~

Financial Statement Disclosures

…

~~[73] HKSA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*~~

HKSA 500, *Audit Evidence*

Introduction

Scope of this HKSA

1. This Hong Kong Standard on Auditing (HKSA) explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

2. This HKSA is applicable to all the audit evidence obtained during the course of the audit. Other HKSAs deal with specific aspects of the audit (for example, HKSA 315 (Revised)[74]), the audit evidence to be obtained in relation to a particular topic (for example, HKSA 570 (Revised)[75]), specific procedures to obtain audit evidence (for example, HKSA 520[76]), and the evaluation of whether sufficient appropriate audit evidence has been obtained (HKSA 200[77] and HKSA 330[78]).

Effective Date

3. This HKSA is effective for audits of financial statements for periods beginning on or after15 December 2009.

Objective

4. The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

Definitions

5. For purposes of ~~the~~this HKSA, the following terms have the meanings attributed below:

   (a) Accounting records – The records of initial accounting entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries and other adjustments to the financial statements that are not reflected in journal entries; and records such as work sheets and spreadsheets supporting cost allocations, computations, reconciliations and disclosures.

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

   (c) Audit evidence – Information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underlying the financial statements and information obtained from other sources.

   (cA) External information source – An external individual or organization that provides information that has been used by the entity in preparing the financial statements, or that has been obtained by the auditor as audit evidence, when such information is suitable for use by a broad range of users. When information has been provided by an individual or organization acting in the capacity of a management's expert, service organization[79], or

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

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

[76] HKSA 520, *Analytical Procedures*

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

[78] HKSA 330, *The Auditor's Responses to Assessed Risks*

[79] HKSA 402, *Audit Considerations Relating to an Entity Using a Service Organization*, paragraph 8.

auditor's expert[80] the individual or organization is not considered an external information source with respect to that particular information. (Ref: Para. A1a-A1d)

(d) Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

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

Requirements

Sufficient Appropriate Audit Evidence

6. The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)

Information to Be Used as Audit Evidence

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence~~.~~, including information obtained from an external information source. (Ref: Para. A26~~–A33~~-A33g)

8. If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: (Ref: Para. A34–A36)

   (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37-A43)

   (b) Obtain an understanding of the work of that expert; and (Ref: Para. A44-A47)

   (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)

9. When using information produced by the entity, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances:

   (a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49-A50)

   (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

Selecting Items for Testing to Obtain Audit Evidence

10. When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

Inconsistency in, or Doubts over Reliability of, Audit Evidence

11. If:

   (a) audit evidence obtained from one source is inconsistent with that obtained from another; or

   (b) the auditor has doubts over the reliability of information to be used as audit evidence,

   the auditor shall determine what modifications or additions to audit procedures are necessary to resolve the matter, and shall consider the effect of the matter, if any, on other aspects of the audit. (Ref: Para. A57)

[80] HKSA 620, *Using the Work of an Auditor's Expert*, paragraph 6

***

Application and Other Explanatory Material

External Information Source (Ref: Para 5(cA))

A1a. External information sources may include pricing services, governmental organizations, central banks or recognized stock exchanges. Examples of information that may be obtained from external information sources include:

- Prices and pricing related data;
- Macro-economic data, such as historical and forecast unemployment rates and economic growth rates, or census data;
- Credit history data;
- Industry specific data, such as an index of reclamation costs for certain extractive industries, or viewership information or ratings used to determine advertising revenue in the entertainment industry; and
- Mortality tables used to determine liabilities in the life insurance and pension sectors.

A1b. A particular set of information is more likely to be suitable for use by a broad range of users and less likely to be subject to influence by any particular user if the external individual or organization provides it to the public for free, or makes it available to a wide range of users in return for payment of a fee. Judgment may be required in determining whether the information is suitable for use by a broad range of users, taking into account the ability of the entity to influence the external information source.

A1c. An external individual or organization cannot, in respect of any particular set of information, be both an external information source and a management's expert, or service organization or auditor's expert.

A1d. However, an external individual or organization may, for example, be acting as a management's expert when providing a particular set of information, but may be acting as an external information source when providing a different set of information. In some circumstances, professional judgment may be needed to determine whether an external individual or organization is acting as an external information source or as a management's expert with respect to a particular set of information. In other circumstances, the distinction may be clear. For example:

- An external individual or organization may be providing information about real estate prices that is suitable for use by a broad range of users, for example, information made generally available pertaining to a geographical region, and be determined to be an external information source with respect to that set of information. The same external organization may also be acting as a management's or auditor's expert in providing commissioned valuations, with respect to the entity's real estate portfolio specifically tailored for the entity's facts and circumstances.
- Some actuarial organizations publish mortality tables for general use which, when used by an entity, would generally be considered to be information from an external information source. The same actuarial organization may also be a management's expert with respect to different information tailored to the specific circumstances of the entity to help management determine the pension liability for several of the entity's pension plans.
- An external individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the external individual or organization applies that expertise in making an estimate specifically for the entity and that work is used by management in preparing its financial statements, the external individual or organization is likely to be a management's expert with respect to that information. If, on the other hand, that external individual or organization merely provides, to the public, prices or pricing-related data regarding private transactions, and the entity uses that information in its own estimation methods, the external individual or organization is likely to be an external information source with respect to such information.

- An external individual or organization may publish information, suitable for a broad range of users, about risks or conditions in an industry. If used by an entity in preparing its risk disclosures (for example in compliance with HKFRS 7[81]), such information would ordinarily be considered to be information from an external information source. However, if the same type of information has been specifically commissioned by the entity to use its expertise to develop information about those risks, tailored to the entity's circumstances, the external individual or organization is likely to be acting as a management's expert.
- An external individual or organization may apply its expertise in providing information about current and future market trends, which it makes available to, and is suitable for use by, a broad range of users. If used by the entity to help make decisions about assumptions to be used in making accounting estimates, such information is likely to be considered to be information from an external information source. If the same type of information has been commissioned by the entity to address current and future trends relevant to the entity's specific facts and circumstances, the external individual or organization is likely to be acting as a management's expert.

Sufficient Appropriate Audit Evidence (Ref: Para. 6)

A1. Audit evidence is necessary to support the auditor's opinion and report. It is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits (provided the auditor has determined whether changes have occurred since the previous audit that may affect its relevance to the current audit[82]) or a firm's quality control procedures for client acceptance and continuance. In addition ~~to other sources inside and outside the entity~~, the entity's accounting records and other sources internal to the entity are ~~an~~ important sources of audit evidence. ~~Also, information~~Information that may be used as audit evidence may have been prepared using the work of a management's expert~~.~~ or be obtained from an external information source. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions. In addition, in some cases the absence of information (for example, management's refusal to provide a requested representation) is used by the auditor, and therefore, also constitutes audit evidence

A2. Most of the auditor's work in forming the auditor's opinion consists of obtaining and evaluating audit evidence. Audit procedures to obtain audit evidence can include inspection, observation, confirmation, recalculation, reperformance, and analytical procedures, often in some combination, in addition to inquiry. Although inquiry may provide important audit evidence, and may even produce evidence of a misstatement, inquiry alone ordinarily does not provide sufficient audit evidence of the absence of a material misstatement at the assertion level, nor of the operating effectiveness of controls.

A3. As explained in HKSA 200,[83] reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

A4. The sufficiency and appropriateness of audit evidence are interrelated. Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

A5. Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

[81] Hong Kong Financial Reporting Standards 7 (HKFRS), *Financial Instruments: Disclosures*

[82] HKSA 315 (Revised), paragraph 9

[83] HKSA 200, paragraph 5

A6. HKSA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained.[84] Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. HKSA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

Sources of Audit Evidence

A7. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.

A8. More assurance is ordinarily obtained from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from audit evidence that is generated internally, such as evidence existing within the accounting records, minutes of meetings, or a management representation.

A9. Information from sources independent of the entity that the auditor may use as audit evidence may include confirmations from third parties~~,~~ and information from an external information source, including analysts' reports, and comparable data about competitors (benchmarking data).

Audit Procedures for Obtaining Audit Evidence

A10. As required by, and explained further in, HKSA 315 (Revised) and HKSA 330, audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(a) Risk assessment procedures; and

(b) Further audit procedures, which comprise:

(i) Tests of controls, when required by the HKSA or when the auditor has chosen to do so; and

(ii) Substantive procedures, including tests of details and substantive analytical procedures.

A11. The audit procedures described in paragraphs A14-A25 below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor. As explained in HKSA 330, audit evidence obtained from previous audits may, in certain circumstances, provide appropriate audit evidence where the auditor performs audit procedures to establish its continuing relevance.[85]

A12. The nature and timing of the audit procedures to be used may be affected by the fact that some of the accounting data and other information may be available only in electronic form or only at certain points or periods in time. For example, source documents, such as purchase orders and invoices, may exist only in electronic form when an entity uses electronic commerce, or may be discarded after scanning when an entity uses image processing systems to facilitate storage and reference.

[84] HKSA 330, paragraph 26

[85] HKSA 330, paragraph A35

A13. Certain electronic information may not be retrievable after a specified period of time, for example, if files are changed and if backup files do not exist. Accordingly, the auditor may find it necessary as a result of an entity's data retention policies to request retention of some information for the auditor's review or to perform audit procedures at a time when the information is available.

Inspection

A14. Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records for evidence of authorization.

A15. Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting policies, such as revenue recognition.

A16. Inspection of tangible assets may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items may accompany the observation of inventory counting.

Observation

A17. Observation consists of looking at a process or procedure being performed by others, for example, the auditor's observation of inventory counting by the entity's personnel, or of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure, but is limited to the point in time at which the observation takes place, and by the fact that the act of being observed may affect how the process or procedure is performed. See HKSA 501 for further guidance on observation of the counting of inventory.[86]

External Confirmation

A18. An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium. External confirmation procedures frequently are relevant when addressing assertions associated with certain account balances and their elements. However, external confirmations need not be restricted to account balances only. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request may be designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. External confirmation procedures also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition. See HKSA 505 for further guidance.[87]

Recalculation

A19. Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.

Reperformance

A20. Reperformance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

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[86] HKSA 501, *Audit Evidence—Specific Considerations for Selected Items*

[87] HKSA 505, *External Confirmations*

Analytical Procedures

A21. Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. See HKSA 520 for further guidance.

Inquiry

A22. Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity. Inquiry is used extensively throughout the audit in addition to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

A23. Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

A24. Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information to corroborate the evidence obtained through inquiry.

A25. In respect of some matters, the auditor may consider it necessary to obtain written representations from management and, where appropriate, those charged with governance to confirm responses to oral inquiries. See HKSA 580 for further guidance.[88]

Information to Be Used as Audit Evidence

Relevance and Reliability (Ref: Para. 7)

A26. As noted in paragraph A1, while audit evidence is primarily obtained from audit procedures performed during the course of the audit, it may also include information obtained from other sources such as, for example, previous audits, in certain circumstances, a firm's quality control procedures for client acceptance and continuance and complying with certain additional responsibilities under law, regulation or relevant ethical requirements (e.g., regarding an entity's non-compliance with laws and regulations). The quality of all audit evidence is affected by the relevance and reliability of the information upon which it is based.

Relevance

A27. Relevance deals with the logical connection with, or bearing upon, the purpose of the audit procedure and, where appropriate, the assertion under consideration. The relevance of information to be used as audit evidence may be affected by the direction of testing. For example, if the purpose of an audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements, and unmatched receiving reports may be relevant.

A28. A given set of audit procedures may provide audit evidence that is relevant to certain assertions, but not others. For example, inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cutoff. Similarly, obtaining audit evidence regarding a particular assertion, for

[88] HKSA 580, *Written Representations*

example, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory. On the other hand, audit evidence from different sources or of a different nature may often be relevant to the same assertion.

A29. Tests of controls are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. Designing tests of controls to obtain relevant audit evidence includes identifying conditions (characteristics or attributes) that indicate performance of a control, and deviation conditions which indicate departures from adequate performance. The presence or absence of those conditions can then be tested by the auditor.

A30. Substantive procedures are designed to detect material misstatements at the assertion level. They comprise tests of details and substantive analytical procedures. Designing substantive procedures includes identifying conditions relevant to the purpose of the test that constitute a misstatement in the relevant assertion.

Reliability

A31. The reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalizations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from ~~an~~a source independent ~~external source~~of the entity may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.

A32. HKSA 520 provides further guidance regarding the reliability of data used for purposes of designing analytical procedures as substantive procedures.[89]

A33. HKSA 240 deals with circumstances where the auditor has reason to believe that a document may not be authentic, or may have been modified without that modification having been disclosed to the auditor.[90]

[89] HKSA 520, paragraph 5(a)

[90] HKSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 13

A33a is a conforming amendments to HKSA 500 as a result of the approval of HKSA 250 (Revised)

A33a. HKSA 250 (Revised)[91] provides further guidance with respect to the auditor complying with any additional responsibilities under law, regulation or relevant ethical requirements regarding an entity's identified or suspected non-compliance with laws and regulations that may provide further information that is relevant to the auditor's work in accordance with HKSAs and evaluating the implications of such non-compliance in relation to other aspects of the audit.

External Information Sources

A33b. The auditor is required by paragraph 7 to consider the relevance and reliability of information obtained from an external information source that is to be used as audit evidence, regardless of whether that information has been used by the entity in preparing the financial statements or obtained by the auditor. For information obtained from an external information source, that consideration may, in certain cases, include audit evidence about the external information source or the preparation of the information by the external information source, obtained through designing and performing further audit procedures in accordance with HKSA 330 or, where applicable, HKSA 540 (Revised).[92]

A33c. Obtaining an understanding of why management or, when applicable, a management's expert uses an external information source, and how the relevance and reliability of the information was considered (including its accuracy and completeness), may help to inform the auditor's consideration of the relevance and reliability of that information.

A33d. The following factors may be important when considering the relevance and reliability of information obtained from an external information source, including its accuracy and completeness, taking into account that some of these factors may only be relevant when the information has been used by management in preparing the financial statements or has been obtained by the auditor:

- The nature and authority of the external information source. For example, a central bank or government statistics office with a legislative mandate to provide industry information to the public is likely to be an authority for certain types of information;
- The ability to influence the information obtained, through relationships between the entity and the information source;
- The competence and reputation of the external information source with respect to the information, including whether, in the auditor's professional judgment, the information is routinely provided by a source with a track record of providing reliable information;
- Past experience of the auditor with the reliability of the information provided by the external information source;
- Evidence of general market acceptance by users of the relevance and/or reliability of information from an external information source for a similar purpose to that for which the information has been used by management or the auditor;
- Whether the entity has in place controls to address the relevance and reliability of the information obtained and used;
- Whether the external information source accumulates overall market information or engages directly in "setting" market transactions;
- Whether the information is suitable for use in the manner in which it is being used and, if applicable, was developed taking into account the applicable financial reporting framework;
- Alternative information that may contradict the information used;
- The nature and extent of disclaimers or other restrictive language relating to the

[91] HKSA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements,* paragraph 9

[92] HKSA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

information obtained;

- Information about the methods used in preparing the information, how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods; and
- When available, information relevant to considering the appropriateness of assumptions and other data applied by the external information sources in developing the information obtained.

A33e. The nature and extent of the auditor's consideration takes into account the assessed risks of material misstatement at the assertion level to which the use of the external information is relevant, the degree to which the use of that information is relevant to the reasons for the assessed risks of material misstatement and the possibility that the information from the external information source may not be reliable (for example, whether it is from a credible source). Based on the auditor's consideration of the matters described in paragraph A33b, the auditor may determine that further understanding of the entity and its environment, including its internal control, is needed, in accordance with HKSA 315, or that further audit procedures, in accordance with HKSA 330[93], and HKSA 540 (Revised)[94] when applicable, are appropriate in the circumstances, to respond to the assessed risks of material misstatement related to the use of information from an external information source. Such procedures may include:

- Performing a comparison of information obtained from the external information source with information obtained from an alternative independent information source.
- When relevant to considering management's use of an external information source, obtaining an understanding of controls management has in place to consider the reliability of the information from external information sources, and potentially testing the operating effectiveness of such controls.
- Performing procedures to obtain information from the external information source to understand its processes, techniques, and assumptions, for the purposes of identifying, understanding and, when relevant, testing the operating effectiveness of its controls.

A33f. In some situations, there may be only one provider of certain information, for example, information from a central bank or government, such as an inflation rate, or a single recognized industry body. In such cases, the auditor's determination of the nature and extent of audit procedures that may be appropriate in the circumstances is influenced by the nature and credibility of the source of the information, the assessed risks of material misstatement to which that external information is relevant, and the degree to which the use of that information is relevant to the reasons for the assessed risk of material misstatement. For example, when the information is from a credible authoritative source, the extent of the auditor's further audit procedures may be less extensive, such as corroborating the information to the source's website or published information. In other cases, if a source is not assessed as credible, the auditor may determine that more extensive procedures are appropriate and, in the absence of any alternative independent information source against which to compare, may consider whether performing procedures to obtain information from the external information source, when practical, is appropriate in order to obtain sufficient appropriate audit evidence.

A33g. When the auditor does not have a sufficient basis with which to consider the relevance and reliability of information from an external information source, the auditor may have a limitation on scope if sufficient appropriate audit evidence cannot be obtained through alternative procedures. Any imposed limitation on scope is evaluated in accordance with the requirements of HKSA 705 (Revised).[95]

Reliability of Information Produced by a Management's Expert (Ref: Para. 8)

A34. The preparation of an entity's financial statements may require expertise in a field other than accounting or auditing, such as actuarial calculations, valuations, or engineering data. The

93 HKSA 330, paragraph 6

94 HKSA 540 (Revised), paragraph 30

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

entity may employ or engage experts in these fields to obtain the needed expertise to prepare the financial statements. Failure to do so when such expertise is necessary increases the risks of material misstatement.

A35. When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this HKSA applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this HKSA~~,~~ ~~but is~~ being information from an external information source and not the use of a management's expert by the entity.

A36. The nature, timing and extent of audit procedures in relation to the requirement in paragraph 8 of this HKSA, may be affected by such matters as:

- The nature and complexity of the matter to which the management's expert relates.
- The risks of material misstatement in the matter.
- The availability of alternative sources of audit evidence.
- The nature, scope and objectives of the management's expert's work.
- Whether the management's expert is employed by the entity, or is a party engaged by it to provide relevant services.
- The extent to which management can exercise control or influence over the work of the management's expert.
- Whether the management's expert is subject to technical performance standards or other professional or industry requirements.
- The nature and extent of any controls within the entity over the management's expert's work.
- The auditor's knowledge and experience of the management's expert's field of expertise.
- The auditor's previous experience of the work of that expert.

The Competence, Capabilities and Objectivity of a Management's Expert (Ref: Para. 8(a))

A37. Competence relates to the nature and level of expertise of the management's expert. Capability relates the ability of the management's expert to exercise that competence in the circumstances. Factors that influence capability may include, for example, geographic location, and the availability of time and resources. Objectivity relates to the possible effects that bias, conflict of interest or the influence of others may have on the professional or business judgment of the management's expert. The competence, capabilities and objectivity of a management's expert, and any controls within the entity over that expert's work, are important factors in relation to the reliability of any information produced by a management's expert.

A38. Information regarding the competence, capabilities and objectivity of a management's expert may come from a variety of sources, such as:

- Personal experience with previous work of that expert.
- Discussions with that expert.
- Discussions with others who are familiar with that expert's work.
- Knowledge of that expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition.
- Published papers or books written by that expert.

- An auditor's expert, if any, who assists the auditor in obtaining sufficient appropriate audit evidence with respect to information produced by the management's expert.

A39. Matters relevant to evaluating the competence, capabilities and objectivity of a management's expert include whether that expert's work is subject to technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association, accreditation standards of a licensing body, or requirements imposed by law or regulation.

A40. Other matters that may be relevant include:

- The relevance of the management's expert's competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, a particular actuary may specialize in property and casualty insurance, but have limited expertise regarding pension calculations.
- The management's expert's competence with respect to relevant accounting requirements, for example, knowledge of assumptions and methods, including models where applicable, that are consistent with the applicable financial reporting framework.
- Whether unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures indicate that it may be necessary to reconsider the initial evaluation of the competence, capabilities and objectivity of the management's expert as the audit progresses.

A41. A broad range of circumstances may threaten objectivity, for example, self-interest threats, advocacy threats, familiarity threats, self-review threats and intimidation threats. Safeguards may reduce such threats, and may be created either by external structures (for example, the management's expert's profession, legislation or regulation), or by the management's expert's work environment (for example, quality control policies and procedures).

A42. Although safeguards cannot eliminate all threats to a management's expert's objectivity, threats such as intimidation threats may be of less significance to an expert engaged by the entity than to an expert employed by the entity, and the effectiveness of safeguards such as quality control policies and procedures may be greater. Because the threat to objectivity created by being an employee of the entity will always be present, an expert employed by the entity cannot ordinarily be regarded as being more likely to be objective than other employees of the entity.

A43. When evaluating the objectivity of an expert engaged by the entity, it may be relevant to discuss with management and that expert any interests and relationships that may create threats to the expert's objectivity, and any applicable safeguards, including any professional requirements that apply to the expert; and to evaluate whether the safeguards are adequate. Interests and relationships creating threats may include:

- Financial interests.
- Business and personal relationships.
- Provision of other services.

Obtaining an Understanding of the Work of the Management's Expert (Ref: Para. 8(b))

A44. An understanding of the work of the management's expert includes an understanding of the relevant field of expertise. An understanding of the relevant field of expertise may be obtained in conjunction with the auditor's determination of whether the auditor has the expertise to evaluate the work of the management's expert, or whether the auditor needs an auditor's expert for this purpose.[96]

A45. Aspects of the management's expert's field relevant to the auditor's understanding may include:

- Whether that expert's field has areas of specialty within it that are relevant to the audit.
- Whether any professional or other standards, and regulatory or legal requirements apply.

[96] HKSA 620, ~~*Using the Work of an Auditor's Expert*,~~ paragraph 7

- What assumptions and methods are used by the management's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
- The nature of internal and external data or information the management's expert uses.

A46. In the case of a management's expert engaged by the entity, there will ordinarily be an engagement letter or other written form of agreement between the entity and that expert. Evaluating that agreement when obtaining an understanding of the work of the management's expert may assist the auditor in determining the appropriateness of the following for the auditor's purposes:

- The nature, scope and objectives of that expert's work;
- The respective roles and responsibilities of management and that expert; and
- The nature, timing and extent of communication between management and that expert, including the form of any report to be provided by that expert.

A47. In the case of a management's expert employed by the entity, it is less likely there will be a written agreement of this kind. Inquiry of the expert and other members of management may be the most appropriate way for the auditor to obtain the necessary understanding

Evaluating the Appropriateness of the Management's Expert's Work (Ref: Para. 8(c))

A48. Considerations when evaluating the appropriateness of the management's expert's work as audit evidence for the relevant assertion may include:

- The relevance and reasonableness of that expert's findings or conclusions, their consistency with other audit evidence, and whether they have been appropriately reflected in the financial statements;
- If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods; ~~and~~
- If that expert's work involves significant use of source data, the relevance, completeness, and accuracy of that source data; and
- If that expert's work involves the use of information from an external information source, the relevance and reliability of that information.

Information Produced by the Entity and Used for the Auditor's Purposes (Ref: Para. 9(a)–(b))

A49. In order for the auditor to obtain reliable audit evidence, information produced by the entity that is used for performing audit procedures needs to be sufficiently complete and accurate. For example, the effectiveness of auditing revenue by applying standard prices to records of sales volume is affected by the accuracy of the price information and the completeness and accuracy of the sales volume data. Similarly, if the auditor intends to test a population (for example, payments) for a certain characteristic (for example, authorization), the results of the test will be less reliable if the population from which items are selected for testing is not complete.

A50. Obtaining audit evidence about the accuracy and completeness of such information may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence is an integral part of the audit procedure itself. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the preparation and maintenance of the information. In some situations, however, the auditor may determine that additional audit procedures are needed.

A51. In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to make use of the entity's performance measures for the purpose of analytical procedures, or to make use of the entity's information produced for monitoring activities, such as reports of the internal audit function. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

Selecting Items for Testing to Obtain Audit Evidence (Ref: Para. 10)

A52. An effective test provides appropriate audit evidence to an extent that, taken with other audit evidence obtained or to be obtained, will be sufficient for the auditor's purposes. In selecting items for testing, the auditor is required by paragraph 7 to determine the relevance and reliability of information to be used as audit evidence; the other aspect of effectiveness (sufficiency) is an important consideration in selecting items to test. The means available to the auditor for selecting items for testing are:

(a) Selecting all items (100% examination);

(b) Selecting specific items; and

(c) Audit sampling.

The application of any one or combination of these means may be appropriate depending on the particular circumstances, for example, the risks of material misstatement related to the assertion being tested, and the practicality and efficiency of the different means.

Selecting All Items

A53. The auditor may decide that it will be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100% examination is unlikely in the case of tests of controls; however, it is more common for tests of details. 100% examination may be appropriate when, for example:

- The population constitutes a small number of large value items;
- There is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- The repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Selecting Specific Items

A54. The auditor may decide to select specific items from a population. In making this decision, factors that may be relevant include the auditor's understanding of the entity, the assessed risks of material misstatement, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- *High value or key items*. The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example, items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- *All items over a certain amount*. The auditor may decide to examine items whose recorded values exceed a certain amount so as to verify a large proportion of the total amount of a class of transactions or account balance.
- *Items to obtain information*. The auditor may examine items to obtain information about matters such as the nature of the entity, or the nature of transactions.

A55. While selective examination of specific items from a class of transactions or account balance will often be an efficient means of obtaining audit evidence, it does not constitute audit sampling. The results of audit procedures applied to items selected in this way cannot be projected to the entire population; accordingly, selective examination of specific items does not provide audit evidence concerning the remainder of the population.

Audit Sampling

A56. Audit sampling is designed to enable conclusions to be drawn about an entire population on the basis of testing a sample drawn from it. Audit sampling is discussed in HKSA 530.[97]

[97] HKSA 530, *Audit Sampling*

Inconsistency in, or Doubts over Reliability of, Audit Evidence (Ref: Para. 11)

A57. Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal auditors, and others are inconsistent, or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. HKSA 230 includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter.[98]

[98] HKSA 230, *Audit Documentation*, paragraph 11

HKSA 580, *Written Representations*

…

Appendix 1

(Ref: Para. 2)

List of HKSAs Containing Requirements for Written Representations

This appendix identifies paragraphs in other HKSAs that require subject-matter specific written representations. The list is not a substitute for considering the requirements and related application and other explanatory material in HKSAs.

- HKSA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements – paragraph 39
- HKSA 250, Consideration of Laws and Regulations in an Audit of Financial Statements – paragraph 16; HKSA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 17
- HKSA 450, Evaluation of Misstatements Identified during the Audit – paragraph 14
- HKSA 501, Audit Evidence—Specific Considerations for Selected Items – paragraph 12
- HKSA 540 (Revised), Auditing Accounting Estimates~~, Including Fair Value Accounting Estimates,~~ and Related Disclosures – paragraph ~~22~~37
- HKSA 550, Related Parties – paragraph 26
- HKSA 560, Subsequent Events – paragraph 9
- HKSA 570 (Revised), Going Concern – paragraph 16(e)
- HKSA 710, Comparative Information—Corresponding Figures and Comparative Financial Statements – paragraph 9
- HKSA 720 (Revised), The Auditor's Responsibilities Relating to Other Information – paragraph 13(c)

Appendix 2

(Ref: Para. A21)

Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other HKSAs. It is assumed in this illustration that the applicable financial reporting framework is Hong Kong Financial Reporting Standards; the requirement of HKSA 570 (Revised)[99] to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended 31 December 20XX[100] for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with Hong Kong Financial Reporting Standards.

We confirm that (*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):[100a]

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with Hong Kong Financial Reporting Standards; in particular the financial statements are fairly presented (or give a true and fair view) in accordance therewith.
- ~~Significant~~ The methods, the data, and the significant assumptions used by us in making accounting estimates~~, including those measured at fair value,~~ and their related disclosures are appropriate to achieve recognition, measurement or disclosure that is reasonable in the context of the applicable financial reporting framework. (HKSA 540 (Revised))
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of Hong Kong Financial Reporting Standards. (HKSA 550)

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99 HKSA 570 (Revised), *Going Concern*

100 Where the auditor reports on more than one period, the auditor adjusts the date so that the letter pertains to all periods covered by the auditor's report.

100a The following additional management representations are applicable to audits of companies incorporated under the Companies Ordinance:

- We acknowledge that section 380 of the Companies Ordinance requires us to prepare financial statements which give a true and fair view of the financial position of the company as at the end of the financial year and of the financial performance of the company for the financial year.
- We are responsible for taking all reasonable steps to ensure the company keeps proper accounting records which are sufficient to show and explain the company's transactions, disclose with reasonable accuracy at any time the company's financial position and financial performance and to ensure that the financial statements comply with the Companies Ordinance.
- The financial statements comply with section 383 (Notes to Financial Statements to Contain Information on Directors' Emoluments etc) of the Companies Ordinance which must contain in the notes to the financial statements, the information prescribed by the Companies (Disclosure of Information about Benefits of Directors) Regulation (Cap. 622G).
- We are responsible for the preparation of the director's report that
  - (a) complies with sections 390 (Contents of Directors' Report: General) and 543(2) (Disclosure of Management Contract) and Schedule 5 (Contents of Directors' Report: Business Review) of the Companies Ordinance;
  - (b) contains the information prescribed by the regulations made under section 452(3) (Financial Secretary May Make Other Regulations) of the Companies Ordinance; and
  - (c) complies with other requirements prescribed by the regulations made under section 452 (3) of the Companies Ordinance.

HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

…

Requirements

…

Forming an Opinion on the Financial Statements

…

13. In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

    (a) The financial statements appropriately disclose the significant accounting policies selected and applied. In making this evaluation, the auditor shall consider the relevance of the accounting policies to the entity, and whether they have been presented in an understandable manner; (Ref: Para. A4)

    (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

    (c) The accounting estimates <u>and related disclosures</u> made by management are reasonable;

    (d) The information presented in the financial statements is relevant, reliable, comparable, and understandable. In making this evaluation, the auditor shall consider whether:

    - The information that should have been included has been included, and whether such information is appropriately classified, aggregated or disaggregated, and characterized.
    - The overall presentation of the financial statements has been undermined by including information that is not relevant or that obscures a proper understanding of the matters disclosed. (Ref: Para. A5)

    (e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and (Ref: Para. A6)

    (f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

…

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

…

Requirements

…

Determining Key Audit Matters

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)

   (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with HKSA 315 (Revised)[101]. (Ref: Para. A19–A22)

   (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that ~~have~~ are subject to~~been identified as having~~ a high degree of estimation uncertainty. (Ref: Para. A23–A24)

   (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

…

Application and Other Explanatory Material

…

Significant Auditor Judgments Relating to Areas in the Financial Statements that Involved Significant Management Judgment, Including Accounting Estimates that ~~Have Been Identified as~~ Are Subject to a High Degree of Estimation Uncertainty (Ref: Para. 9(b))

A23 HKSA 260 (Revised) requires the auditor to communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.[102] In many cases, this relates to critical accounting estimates and related disclosures, which are likely to be areas of significant auditor attention, and also may be identified as significant risks.

A24 However, users of the financial statements have highlighted their interest in accounting estimates that ~~have~~ are subject to a ~~been identified as having~~high degree of estimation uncertainty (see~~in accordance with~~ HKSA 540 (Revised)[103]) that may have not been determined to be significant risks. Among other things, such estimates are highly dependent on management judgment and are often the most complex areas of the financial statements, and may require the involvement of both a management's expert and an auditor's expert. Users have also highlighted that accounting policies that have a significant effect on the financial statements (and significant changes to those policies) are relevant to their understanding of the financial statements, especially in circumstances where an entity's practices are not consistent with others in its industry.

…

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

[102] HKSA 260 (Revised), paragraph 16(a)

[103] See paragraphs 16~~0~~–17~~1~~ of HKSA 540 (Revised), *Auditing Accounting Estimates*~~, *Including Fair Value Accounting Estimates*,~~ *and Related Disclosures*.

PN 830 (Revised)
Issued December 2014; revised April 2016,
revised December 2018

Effective for reporting periods ending
on or after 1 January 2019

Practice Note 830 (Revised)

Reports by the Auditor under the Banking Ordinance

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

PRACTICE NOTE 830 (REVISED)

REPORTS BY THE AUDITOR UNDER THE BANKING ORDINANCE

(Issued December 2014; revised April 2016, revised December 2018
Effective for reporting periods ending on or after 1 January 2019)

CONTENTS

Practice Note (PN) 830 (Revised), *Reports by the Auditor under the Banking Ordinance* should be read in the context of the "Amended Preface to the Hong Kong Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements" which sets out the application and authority of PNs.

PRACTICE NOTE
830 (REVISED)
REPORTS BY THE AUDITOR UNDER THE BANKING ORDINANCE

The purpose of Practice Notes issued by the Hong Kong Institute of Certified Public Accountants (HKICPA) is to assist the auditor in applying Hong Kong Engagement Standards of general application to particular circumstances and industries.

Practice Notes are persuasive rather than prescriptive. However they are indicative of good practice and have similar status to the explanatory material in Hong Kong Engagement Standards. This Practice Note provides guidance to assist the auditor to fulfill the objectives of the engagement. The auditor should be prepared to explain departures when called upon to do so.

PART I – INTRODUCTION

1. In this Practice Note ("PN") all the sections mentioned below are in respect of the Banking Ordinance ("Ordinance") unless otherwise stated.

2. The purpose of this PN is to assist the auditor of authorized institutions ("AIs") in reporting under the Ordinance.

3. This PN provides guidance to members on the reporting responsibilities of the auditor appointed for the purposes of sections 50(1)(c), 59(2), 63(3) and 63(3A). Guidance is also provided on other reports and notifications issued by the auditor, including notification of audit qualifications or adverse statements under section 59A(2)(c), reporting of significant adverse matters and non-compliances under sections 63A and 63B, notification of resignation of the auditor under section 59A(2) and report of factual findings in relation to voluntary revocation of authorization of an AI. These are dealt with in Part II.

4. Guidance on auditor's ad hoc communications with the Hong Kong Monetary Authority ("HKMA") under the protection of section 61 is set out in Part III.

5. This PN is not intended to provide detailed guidance on the general audit procedures to be adopted in respect of the audit of the financial statements of an AI and does not apply to other reports provided by the auditor, such as those provided under the Companies Ordinance on financial statements. Guidance on auditor's report on financial statements is set out in HKSA 700, "Forming an Opinion and Reporting on Financial Statements" and Practice Note 600.1 (Revised) "Reports by the Auditor under the Hong Kong Companies Ordinance (Cap. 622)".

6. In addition to the reporting responsibilities under the Ordinance, the auditor is required to report to the relevant authorities in accordance with the Drug Trafficking (Recovery of Proceeds) Ordinance, the Organized and Serious Crimes Ordinance and the United Nations (Anti-Terrorism Measures) Ordinance for the purpose of combating money laundering and terrorism. The auditor may also be required by the Deposit Protection Board to report on the Return of Relevant Deposits for the purpose of the Deposit Protection Board. This PN does not provide guidance with respect to these responsibilities.

7. This PN also contains in Appendix 5 a guide to the relevant provisions for the auditor in the Ordinance which were effective as at 31 July 2018. Every care has been taken in its preparation. However, the legislation itself is the sole authority of the law and this PN should be used in conjunction with the legislation.

8. It should be borne in mind that certain expressions used in the Ordinance may be matters for legal interpretation. There may, therefore, be circumstances in which, notwithstanding the guidance given in this PN, members will wish to seek legal advice.

9. The term Monetary Authority in the Ordinance refers to a person appointed by the Financial Secretary under the Exchange Fund Ordinance. The HKMA is the government authority in Hong Kong responsible for maintaining monetary and banking stability and is headed by the Monetary Authority. In this PN, the term "HKMA" is used generally to refer to the organization as a whole. The term "Monetary Authority" is used when quoting a specific reference from the Ordinance and in the auditor's reports under the Ordinance.

10. The PN has been prepared in consultation with the HKMA.

PART II – AUDITOR'S REPORTING RESPONSIBILITIES UNDER THE ORDINANCE

Introduction

11. The auditor is normally appointed by the AI with the approval of the HKMA for the purpose of preparing certain reports under the Ordinance. The Ordinance generally recognizes the auditor as a person appointed by the shareholders of a locally incorporated AI under the Companies Ordinance to report on whether the AI's financial statements give a true and fair view ("statutory auditor") or those appointed by the AI to submit a report to the HKMA under section 59(2), 63(3) or 63(3A). Submission of reports by the auditor under the Ordinance (except reporting under section 59(2)) is normally carried out by an AI's statutory auditor although the HKMA has the right to commission reports from another audit firm where:

a. such an arrangement can better utilize the knowledge and expertise of different auditor which may be beneficial to the AI; or

b. the HKMA has reason to believe that the statutory auditor would not be capable of producing an adequate report, after taking into account:

– the reputation of the statutory auditor;
– the quality of reports previously submitted to the HKMA by the statutory auditor;
– the expertise, knowledge and resources of the statutory auditor; and
– any potential conflict of interest on the part of the statutory auditor.

Even where there are no doubts about the capability or independence of the statutory auditor, the HKMA may require that a report under section 59(2) be obtained from another audit firm to obtain a fresh perspective on matters which are the subject of the report.

12. The auditor has a number of reporting responsibilities under the Ordinance. These include:

a. Regular reports

- Reporting on specified banking returns (section 63(3)) (see paragraphs 38 to 67 below);

- Reporting on systems of control over the compilation of banking returns, compliance with specified sections of the Ordinance and maintenance of adequate provision (section 63(3A)) (see paragraphs 68 to 104 below).

b. Other reports

- Ad hoc reporting on internal controls, specific transactions or any other matters (section 59(2)) (see paragraphs 105 to 127 below);

- Notification of audit qualifications or adverse statements in audit reports on AI's financial statements (section 59A(2)(c)) (see paragraphs 128 to 130 below);

- Reporting of significant adverse matters and non-compliances (sections 63A and 63B) (see paragraphs 131 to 139 below);

- Notification of resignation of the auditor (section 59A(2)) (see paragraph 140 below);

Apart from the specific provisions in the Ordinance set out above, the HKMA may also reasonably require the AI to appoint an auditor to examine and report upon specific subject matters or transactions undertaken by the AI as it deems fit for the exercise of its supervisory functions under the Ordinance. The auditor may want to consider the guidance set out in this PN in discharging its reporting responsibilities under these circumstances as appropriate.

c. Under section 50(1)(c), locally incorporated AIs which maintain an overseas branch may need to appoint an auditor, if the HKMA so requires, to report on whether a return or information submitted by them in respect of their overseas branch(es) is correctly compiled, in all material respects, from the books and records of the branch(es).

13. The auditor is also normally requested to furnish a report on voluntary revocation of an AI's authorization to the HKMA in respect of the balance sheet[1], third party deposit liabilities, contingent liabilities and outstanding commitments (see paragraphs 141 to 146 below).

14. The HKMA issues specific completion instructions and guidelines to AIs on the compilation of banking returns and on meeting the provisions of the Ordinance. In its Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance"[2], the HKMA also provides a description of the nature of some of the controls and procedures it expects AIs to have in place to demonstrate adequate controls over compilation of banking returns and compliance with the provisions in the Ordinance. The auditor would have regard to the requirements set out in Supervisory Policy Manual IC-3 in fulfilling the reporting responsibilities under the Ordinance.

General guidance

Types of engagements under the Ordinance

15. The auditor's reporting responsibilities under the Ordinance can generally be categorized as either reasonable assurance engagements, limited assurance engagements, or agreed-upon procedures engagements. The auditor may also provide other forms of reporting on specific subject matter (e.g. review and comment report for an investigation of particular subject matter under section 59(2) of the Ordinance) at the request of the HKMA. The form of such reporting will be determined on a case-by-case basis after taking into account the scope of work required and level of assurance expected by the HKMA.

16. As defined in Hong Kong Standard on Assurance Engagements (HKSAE) 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*, a reasonable assurance engagement is an assurance engagement in which the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for the practitioner's conclusion. The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria.

17. As defined in HKSAE 3000 (Revised), a limited assurance engagement is an assurance engagement in which the practitioner reduces engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement as the basis for expressing a conclusion in a form that conveys whether, based on the procedures performed and evidence obtained, a matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated.

18. The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed, and to report on factual findings. As the auditor simply provides a

1 Different term like statement of financial position may be used in the auditor's report as long as it is consistent with the title of the corresponding statement.

2 As at the date of issuing this revised PN, the HKMA’s Supervisory Policy Manual IC-3 is undergoing revision.

report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report would assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

Overview of the reporting process

19. The following are action steps that the auditor would consider in order to discharge the reporting responsibilities under the Ordinance:

a. Scoping and planning

For reporting under section 63(3) and (3A):

- Assemble the engagement team including any necessary specialists;
- Obtain from the AI the terms of reference (normally called a "Letter of Instruction") identifying the specific banking returns or systems of control to be reported on and the period to be covered;
- Issue a letter of engagement;
- If applicable, obtain the relevant banking returns to be reported on from the AI. In the anticipation of the update of the HKMA's Supervisory Policy Manual IC-3[3], the HKMA has indicated that the returns to be reported on by the auditor would be the latest returns submitted to the HKMA before the commencement of auditor's work (the "Relevant Returns"), unless the HKMA specifies otherwise;
- Where a relevant return has been revised from the originally submitted return, obtain a reconciliation of adjustments between originally submitted return and the Relevant Return from management. Such a reconciliation should contain information as set out in Part A of Appendix 9 of this PN;
- Undertake detailed planning and fieldwork.

For reporting under section 59(2):

- Obtain the draft scope of review prepared by the HKMA and discuss the nature of the appointment with the AI;
- Seek a meeting with the HKMA (at which representatives of the AI should be present), where appropriate, to obtain the background information, including the reasons why the HKMA is requesting the report and the expectations of the HKMA with respect to the engagement. Depending on individual circumstances, the auditor would usually seek to discuss and agree the scope, nature and extent of work with the HKMA and AI through such a meeting;
- Where necessary, hold additional scoping meeting(s) or discussions with the HKMA and the AI to further refine the scope;
- Agree the scope and all other matters that are to be recorded in the Letter of Instruction with the AI and the HKMA;
- Obtain from the AI the Letter of Instruction;

[3] As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.

- Issue a letter of engagement to the AI, incorporating the Letter of Instruction;
- Undertake detailed planning and fieldwork.

b. *Execution*

- If requested by the HKMA, or if considered necessary as a result of issues identified whilst conducting the work, arrange discussions or meetings with the HKMA and/or the AI;
- Incorporate the responses of management (obtained in writing) of the AI to the findings in the final report (if this is the agreed means of communicating management's comments to the HKMA);
- For engagements under section 59(2), arrange with the AI and the HKMA to amend or reissue the Letter of Instruction to reflect any significant matters that come to light during the performance of the work and any changes in scope verbally communicated to the AI or the auditor (if necessary). Ensure that any significant changes in scope are properly described in the report to be issued.

c. *Finalization and reporting*

- Finalize the report with the AI's management comments or responses included, where appropriate;
- Obtain a management representation letter from the AI;
- Issue the final report to the AI for submission to the HKMA;
- For reports under section 59(2), if comments from the AI's management on the draft final report were not incorporated into the auditor's report, obtain a copy of the comments sent by the AI to the HKMA;
- Prepare for and attend any tripartite meeting to discuss the report findings (if necessary).

20. The scope of an engagement under section 63(3) or (3A) is normally considered to be relatively routine and standardized and therefore, some of the above action steps may have been addressed previously and can be carried over into the current period engagement.

Engagement acceptance

21. When undertaking an engagement to provide a report under the Ordinance, the auditor would recognize that throughout the process, there are two parties interested in the report - the AI which engages the auditor; and the HKMA, which has required the AI to commission the report. The auditor would manage the expectations of both parties to reduce the risk of misunderstanding.

22. The auditor would ensure that the scope of the engagement is clear, so that the HKMA and the AI agree, accept and understand the areas to be examined, the form of reporting of the overall findings, the content and structure of the report to be provided and the type and extent of procedures to be undertaken. However, it is the responsibility of the HKMA to determine whether the scope of the work specified in the Letter of Instruction is sufficient for its purposes.

23. For reporting under section 59(2), the HKMA recognizes that usually there will be value in holding discussions involving the auditor concerning the proposed assignment in a tripartite meeting (between the AI, the HKMA and the auditor) or, in less usual circumstances, a bilateral meeting (between the HKMA and the auditor only) but is not bound to do so. This

discussion can usually occur when a draft scope has already been prepared by the HKMA and this would form the basis for the discussion.

24. When approached to undertake an engagement to report under the Ordinance and during the discussion of the scope, the auditor would consider the professional skills required to undertake the engagement.

25. In particular, the auditor would need to have knowledge and understanding of the HKMA's regulatory requirements and the statutory provisions relevant to the scope of the engagement. This is necessary in order to understand and evaluate the scope of the engagement at the outset, and to determine the manner in which the findings in the auditor's report would be presented. In addition, the auditor is required to report, in certain circumstances and without delay, direct to the HKMA and therefore would need to be aware of the relevant provisions.

26. The auditor would need to consider whether previous or existing professional relationships could present a conflict of interest in accepting the engagement. If the auditor becomes aware of relationships with the AI which could be construed as a conflict of interest, the auditor would advise the AI and the HKMA of this issue and all parties have to be satisfied that the auditor is appropriately placed to undertake the assignment objectively.

27. The HKMA has indicated that it would take into account the knowledge and expertise of the statutory auditor and the need for a fresh perspective on matters to be examined when deciding whether to nominate or approve the appointment of the statutory auditor or another audit firm.

28. The auditor and the AI would agree on the terms of the engagement, which would be recorded in an engagement letter or other suitable form of written contract. The auditor would follow the guidance set out in HKSA 210, "Agreeing the Terms of Audit Engagements" and agree the terms of the engagement in relation to the auditor's work performed under the Ordinance.

29. Examples of engagement letters are set out in Appendix 3 to this PN.

Reporting considerations

30. Generally, when making a report, the auditor would apply techniques to keep narrative in the report clear, logically structured and concise, such as using bullet points and tables, and relegating detailed elements to the detailed sections and appendices to the report. The auditor would include specific findings such as exceptions, deficiencies, observations or required recommendations (however defined) arising from the work undertaken together with sufficient background information for the HKMA and the AI to understand the context in which the findings are made and their implications.

31. The auditor would need to be aware that specific findings included in the report can form the basis of supervisory or enforcement action by the HKMA. Therefore, it is important that all relevant matters, which are considered material in the circumstances, be included in the report. When evaluating whether and how to report a specific finding, the auditor would need to recognize that materiality for reporting under the Ordinance may be different to that used in the context of an audit of the financial statements of the AI or an assignment undertaken solely for the AI's management. The auditor would take into account the HKMA's interests in its role as a supervisor, for example by considering the findings in the context of: the HKMA's supervisory objectives; requirements set out in the HKMA's Supervisory Policy Manual in relation to the area examined; and the HKMA's reasons for commissioning a report, including any concerns or issues raised during the scoping discussions. It may also be useful for the auditor to discuss and agree with the HKMA and the AI on the materiality threshold so that what would constitute a matter to be reported as a specific finding and how it will be described are clearly understood between all parties.

32. The materiality threshold is a matter of professional judgment but, unless otherwise agreed with the HKMA, the auditor would normally report all relevant matters other than those considered to be immaterial. This PN provides further guidance for the auditor on materiality for the purpose of the reporting responsibilities under the Ordinance (see paragraphs 60 to 61, 95 to 99 and 120 to 121 below for different engagements).

33. Unless otherwise agreed with the HKMA, where an auditor's engagement for the purpose of reporting under the Ordinance includes the examination of controls over a specified period or transactions during that period, the auditor would include all material findings identified even if the findings identified were corrected during or after the period examined.

34. The auditor would seek management's confirmation of the factual accuracy of information or statements contained in the auditor's report. This may be achieved either by way of a written confirmation from management or as a specific representation from management included in the management representation letter. Examples of management representation letters are set out in Appendix 2 to this PN.

Obtaining management comments

35. For certain types of engagements under the Ordinance (e.g., section 63(3A) reports and section 59(2) reports), the HKMA expects management of the AI to have the opportunity to provide written comments on exceptions contained in the auditor's report prior to its submission to the HKMA. Management may wish to provide the auditor with written comments for incorporation into the auditor's report prior to its issue. Alternatively, management of the AI may choose to provide written comments directly to the HKMA when the AI submits the report to the HKMA.

36. Where the auditor includes management comments in the report prior to its issue, the report would clearly identify the comments of management. The report would also state clearly that the management of the AI is responsible for the accuracy of the comments made, that the auditor takes no responsibility for them and that they are not covered by the auditor's conclusion (or overall findings otherwise provided). A common practice used in the presentation of management letters or internal control reports, which can assist the review of an auditor's report by the HKMA, is to incorporate management comments in the body of the report, against the elements of the report to which the comments relate.

37. Management comments for incorporation in the auditor's report prior to issue would be obtained from, or confirmed in writing by, the AI in order to minimize the risk of error or misunderstanding. Where the auditor issues a report without incorporating management's comments, the auditor would obtain a copy of any comments that management submits directly to the HKMA.

Auditor's report under section 63(3)

General

38. Management of AIs is required by the HKMA to submit a number of returns within an integrated banking statistics system. The HKMA may also require an AI to submit a report, prepared by the auditor, as to whether or not, in the opinion of the auditor, a return submitted to the HKMA is correctly compiled, in all material respects, from the books and records of the AI and, if not so correctly compiled, the nature and extent of the incorrectness. General guidance on the auditor's report on banking returns is provided in the HKMA's Supervisory Policy Manual IC-3[4].

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[4] As at the date of issuing this revised PN, the HKMA's Supervisory Policy Manual IC-3 is undergoing revision.

39. Preparation and submission of the banking returns is the responsibility of the AI's management. The Ordinance makes it an offence for any person who signs any document for the purposes of section 63 which is known or ought to be known to be false in a material particular. Under section 123, it is also an offence for directors, chief executives, managers, trustees, employees and agents of an AI to wilfully deceive by falsifying books and records.

40. The HKMA has emphasized the importance of the banking returns submitted by AIs and can exercise the powers derived from section 63(3) (and section 50(1)(c)) to require AIs to appoint an auditor to examine and report upon the banking returns submitted to the HKMA and any other returns which are used for prudential purposes to enable or assist the HKMA to exercise its duties and functions under the Ordinance. On occasion, the HKMA may require information in addition to the information contained in the banking returns. Such information also falls within the scope of information to be reported upon by the auditor if it is requested by the HKMA under section 63(2).

41. These reporting arrangements are intended to reassure the HKMA about the reliability of the information received from an AI. It will be for the HKMA to determine, in the light of all the information available to it, the type of action, if any, that would be taken for its prudential supervision purposes.

Scope

42. The work that the auditor performs for the purpose of reporting under section 63(3) is a reasonable assurance engagement. The responsibility for correct compilation of returns or other information submitted to the HKMA rests with the management of the AI and the auditor's responsibility is to report on whether specified AI's returns or other information submitted to the HKMA are correctly compiled, in all material respects, from the books and records of the AI based on procedures the auditor performed. Reference should be made to Hong Kong Standard on Assurance Engagements (HKSAE) 3000 (Revised) for details of the standards and guidance on reasonable assurance engagements.

43. Under section 63(3), the HKMA can require particular returns to be reported on by the auditor. It should also be noted that for certain returns, the auditor would normally report only on specified parts of the return. For a locally incorporated AI, the auditor would normally be required to report on all or some of the following returns:

- Return of Capital Adequacy Ratio (All parts);
- Return of Large Exposures (Parts I, II and III, columns 1 – 5);
- Return of Liquidity Position (Part 1 (section (I)) and Part 2 if the AI is a "category 1 institution"; or Part 1 (section (II)) and Part 3 if the AI is a "category 2 institution" – see Appendix 11 paragraph (c);
- Quarterly Analysis of Loans and Advances;
- Return of Mainland Activities; and
- Certificate of compliance with the Ordinance (Parts I – IV).

Overseas incorporated AIs operate in the form of a branch in Hong Kong are not required to maintain a minimum capital adequacy ratio in respect of the branch. Accordingly, the auditor would normally be required to report on all or some of the following returns:

- Return of Large Exposures (Parts I, II and III, columns 1 – 5);
- Return of Liquidity Position (Part 1 (section (I)) and Part 2 if the AI is a "category 1 institution"; or Part 1 (section (II)) and Part 3 if the AI is a "category 2 institution" – see Appendix 11 paragraph (c));
- Quarterly Analysis of Loans and Advances;
- Return of Mainland Activities; and
- Certificate of compliance with the Ordinance.

The HKMA can also require the auditor to report on any other returns, or other information submitted to it under section 63(1) and (2) (and section 50(1)(a) and (b)) as the HKMA considers necessary for a particular AI.

44. The returns to be reported on are normally the most comprehensive in the series. That is, where an AI completes a consolidated return[5], it will be that return which would be reported on. Where it has no subsidiaries, but has overseas branches, it will be the combined return that would be reported on. The HKMA normally selects only one date for the returns to be reported on per year, but may select other returns and dates if it believes the returns are not being completed properly. The date/period will not necessarily coincide with the end of the AI's financial year. The date will be determined by the HKMA retrospectively after the due submission date of the returns concerned.

45. When errors are identified in the returns submitted to the HKMA, AIs would, depending on materiality, make suitable amendments to the returns and re-submit these to the HKMA. In the anticipation of the update of the HKMA's Supervisory Policy Manual IC-3[6], the HKMA has indicated that the Relevant Returns to be reported on by the auditor would be the latest returns submitted to the HKMA before the commencement of auditor’s work, unless the HKMA specifies otherwise. Auditors should specify in their reports the submission dates of the returns that have been reviewed by them.

Nature of work

46. The work to be carried out for the purpose of reporting under section 63(3) involves agreeing amounts contained in the Relevant Returns to appropriate records maintained by the AI and checking whether the amounts have been properly compiled based on the completion instructions issued by the HKMA.

47. The auditor would normally review copies of the following documents when planning the work:

a. in respect of locally incorporated AIs, if it is not the statutory auditor, the latest audited financial statements of the AI together with a copy of the latest management letter issued by the statutory auditor where relevant. The auditor would also seek the AI's permission to discuss any matters relevant to the examination with the statutory auditor;

b. for AIs being branches of overseas incorporated banks, the reporting package or accounts prepared (audited or unaudited) by the AIs for submission to their parent banks for group consolidated financial reporting purpose;

c. all correspondence and all minutes or notes of meetings that the AI has held with the HKMA which are relevant to the auditor's examination of the internal control systems in relation to the Relevant Returns;

d. all internal audit reports for matters that may have implications on section 63(3) reporting;

e. all board and management committee minutes;

f. the Relevant Returns submitted to the HKMA, together with any amendments submitted thereafter.

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5 For liquidity supervision and reporting purposes, an AI's consolidated position may include "specified associated entities" as defined in rule 2(1) of the Banking (Liquidity) Rules.

6 As at the date of issuing this revised PN, the HKMA’s Supervisory Policy Manual IC-3 is undergoing revision.

Testing

48. The nature of testing required will vary from AI to AI as this will be dependent on the nature of the systems and processes used to produce the necessary information for compilation of the returns (e.g. whether processes are automated or performed manually).

49. An engagement under section 63(3) requires the auditor to state whether, in the auditor's opinion, the returns have been correctly compiled, in all material respects, from the books and records of the AI. Accordingly, the work the auditor is expected to perform on specified returns normally involves agreeing relevant amounts in the returns to the AI's books and records and ensuring that the compilation procedures were performed in accordance with the completion instructions issued by the HKMA for the Relevant Returns.

50. The definition of books and records is not specifically set out in the Ordinance. However, the HKMA would expect the information contained in the returns to be consistent with the books and records of the AI. The auditor would consider books and records to include the accounting records, i.e. general ledger (including sub ledgers) and non-accounting records such as reports produced by systems (e.g. loan processing systems) which contain or explain in more specific detail particular items in the general ledger (e.g. exposures to specific counterparties or a breakdown of balances by maturity buckets) and other records which support particular items in the returns such as off-balance sheet exposures.

51. For the purpose of reporting under section 63(3), the auditor would primarily focus on the "downstream" process of extracting data from books and records for the purpose of compiling the banking returns rather than the "upstream" processes that operate to bring data originating from transactions and source documents into systems that produce the books and records. Therefore, the books and records will normally be the transactional level records maintained in the AI's relevant established systems ("downstream" records) and normally do not include the primary source supporting documents ("upstream" records) to these transactional level records.

52. There is no requirement for the auditor to provide an opinion that the books and records are correct and complete but only that the amounts in the return agree with those books or records. It would normally be sufficient to check the items in the return to the working papers used by the AI to prepare the return and to check, on a sample basis, the compilation of the amounts contained in such working papers to books and records. For accounting records, the books and records would normally be the general ledger or sub ledgers whilst for non-accounting records, these would normally be reports generated from established systems that produce or maintain the relevant transaction records; and, where applicable, the auditor should reconcile the amounts contained in the working papers to the general ledger or sub ledgers and/or test-check the information contained in the working papers to reports generated from or database of the established systems. Nevertheless, depending on the risks assessed and circumstances encountered by the auditor during the course of his work (e.g., when the AI has applied or embedded certain interpretations or classification criteria in the completion instructions of the Relevant Returns as part of the "upstream" processes to produce the books and records), additional testing procedures over the books and records should be considered and adopted by the auditor as appropriate.

53. Any material adjustments made to the books and records in the course of compiling the returns should be considered as part of assessing whether the return has been correctly compiled. The auditor would also examine the compilation procedures to ensure they are consistent in all material aspects with the HKMA's current completion instructions (including notes and definitions) and any further written rulings that apply specifically to the particular AI.

54. As the auditor's work normally involves testing items on a sample basis, the auditor would consider the adequacy of the compilation process adopted in the preparation of the Relevant Returns as part of the determination of the sample sizes. For example, the auditor would consider whether the definitions and interpretations used in compiling the information are appropriate, whether the controls are adequate to prevent and detect errors in the

compilation of the banking returns, and whether known issues are taken into account in the compilation process. The auditor would refer to HKSA 530, "Audit Sampling" for further guidance in this regard.

55. On occasion, different interpretations of a particular definition or the requirements of the completion instructions may give rise to different results being reported in the returns. Such interpretation is important as definitions and requirements set out in the Ordinance and the HKMA's completion instructions may be worded in a general fashion and management would need to determine how such definitions or requirements should be applied to specific businesses or processes of an AI. Where issues relating to interpretation of the requirements or definition arise, the auditor would consider the following procedures in order to determine whether appropriate interpretation has been adopted:

- Review the documentation maintained by the AI, including any consultation sought with the HKMA, to obtain a detailed understanding of the facts and rationale supporting the interpretation adopted by the AI;

- Review relevant definitions and interpretations contained in the Ordinance, relevant completion instructions and industry practices;

- Request that the AI discusses the issue with relevant officials of the HKMA and seeks written clarification thereon which would include the rationale for any conclusions drawn;

- Determine the need to include an appropriate description of the interpretation adopted to form the basis of the opinion within the auditor's report if in the auditor's judgement, such interpretation is of such importance that it is fundamental to the users' understanding of the information presented in the Relevant Returns. Typically, this can be achieved through including an Emphasis of Matter paragraph in the auditor's report which provides a clear description of the specific interpretation adopted by the AI. The auditor would refer to HKSAE 3000 (Revised), *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* for further guidance in this regard.

Testing procedures

56. The specific procedures to be performed by the auditor in examining the returns for the purpose of reporting under section 63(3) may vary according to the nature, complexity and basis of compilation adopted by the AI for each of the individual returns. Guidance on specific procedures for returns that are more frequently required by the HKMA to be reported on under section 63(3) are set out in Appendix 11 of this PN for reference.

57. The general procedures which the auditor would carry out in respect of the work on the examination of returns for the purpose of reporting under section 63(3) include:

- Obtain an understanding of the purpose and the completion instructions for the Relevant Returns. The purposes of specific returns are taken into consideration in assessing the materiality of any exception identified;

- Review correspondence between the AI and the HKMA to determine whether specific treatments for reporting items in the returns were agreed and adopted by the AI and whether the HKMA has granted specific exemptions to certain requirements for the particular AI;

- Ascertain whether the AI is required to prepare a consolidated return and, if so, determine the entities that are to be included by reviewing the relevant instructions or correspondence issued by the HKMA;

- Understand management's process of compiling the Relevant Returns including any controls that operate to ensure complete and accurate compilation;

- Check that the compilation of amounts in the returns is in accordance with the relevant completion instructions and definitions;

- Test check the calculations on the returns;

- Test check items from the returns to the working papers used by the AI to prepare the returns;

- Test check balances from working papers used by the AI to books and records and vice versa;

- Check whether only amounts which meet the relevant criteria are included in specific line items;

- Reconcile totals to the books and records where appropriate.

Representations by management

58. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management covering, inter alia, the following areas:

  a. acknowledging management's responsibility for establishing and maintaining adequate accounting and non-accounting records and systems of control to ensure that the returns have been correctly compiled from the books and records of the AI and that the AI complies with the provisions of the Ordinance at all times;

  b. stating that all the returns provided to the auditor for the purpose of this engagement are the Relevant Returns submitted to the HKMA;

  c. stating that all transactions undertaken by the AI have been properly reflected and recorded in accounting and any other records and for the compilation of the returns, such records properly reflect the true nature of all transactions;

  d. stating that management has made available to the auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondences with the HKMA, etc.) for the purpose of the auditor's examination of the returns, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;

  e. stating whether there have been any communications between regulatory authorities and the AI concerning non-compliances with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which would have a material effect on the information presented in the returns;

  f. the returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the HKMA;

  g. management acknowledges their responsibility for the preparation of the reconciliation summarizing adjustments made between the original and the Relevant Return (if any);

  h. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVIA (for locally incorporated AIs only) or XVIB of the Ordinance during the relevant period;

  i. management has read the draft auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report; and

j. Management has communicated to the auditor all deficiencies in internal control of which they are aware of that could have a material effect on the information presented in the returns.

59. An example management representation letter is set out in Appendix 2 to this PN – Example 1.

Materiality

60. The HKMA requires errors to be reported where such errors make a material difference to a Relevant Return or are indicative of significant weaknesses in the compilation process. What constitutes material will need to be judged by the auditor on a case-by-case basis but the focus is on the impact on the Relevant Return subject to examination and/or other Relevant Returns that are within the scope of section 63(3) reporting rather than on minor reporting errors.

61. As the specific purpose of each banking return is different, consideration of materiality may need to be varied accordingly and requires an understanding of the purpose of the return and how the information that is reported in the return affect that purpose. A two-tier approach could be considered in which the auditor would assess whether an error is material not only by a general quantitative reference (for example, a difference of 5% or more in a particular line item) but also with reference to relevant benchmarks applicable based on the purpose of the specific return. For example, even where the absolute amount of an error identified in the Return of Capital Adequacy Ratio is not material quantitatively (i.e. does not result in a difference of 5% or more in a particular line item), if it leads to a breach of regulatory Capital Adequacy Ratio limit, such an error will be considered as material. A similar approach can also be considered for other returns such as the Return of Liquidity Position. Notwithstanding the above, the auditor should apply professional judgement in determining the appropriate materiality benchmarks for individual returns. Further guidance on the two-tier materiality approach and suggested materiality benchmarks for the more common returns are included in Appendix 10 of this PN for reference. In addition, the auditor should consider whether the errors identified are individually material or material in aggregate and the qualitative aspects of the errors. Material errors, regardless of their causal factors, should be reported to the HKMA. In this connection, the auditor should gather sufficient evidence to form such judgement. It is expected that the auditor should exercise professional judgement after due consideration of an AI's size, risk profile, business activities and strategy in determining whether any identified error would be of major concern to the HKMA and hence warrant reporting under section 63(3) of the Ordinance.

Reporting

62. A material error would be reported together with an appropriate description of the error as well as the impact on the Relevant Return. Adjustments made as part of finalizing the financial statements or accounting books closing should normally be reflected in the books and records from which the banking returns are compiled. Nevertheless, in certain circumstances and depending on the timing of an AI's financial statements finalization and accounting books closing process, such adjustments may not have been made in the originally submitted returns but are reflected in a revised return which is the Relevant Return. Such adjustments would not be regarded as errors for section 63(3) reporting purposes. However, due care should be exercised by the auditor to evaluate and conclude whether an adjustment made by the AI is exclusively due to timing of AIs' financial statements finalization and accounting books closing process or in fact due to error which should otherwise be captured for section 63(3) reporting purposes.

63. Where errors are identified and there is evidence to suggest that weaknesses in internal controls exist, the auditor would also consider including in the report under section 63(3A) the observations and recommendations on the relevant internal controls for the HKMA and the AI to gain a fuller understanding of the implications of the auditor's findings (see paragraphs 100 to 104 below).

64. An identical copy of the Relevant Returns on which the auditor's report is based would accompany the auditor's report. A summary of the material errors identified by the auditor is recommended to be reported in the format suggested in Part B of Appendix 9 of this PN and set out either within the body of the auditor's report or in an appendix, reference to which is made in the auditor's report.

65. In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised), Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised).

66. The auditor should carry out a reasonable assurance engagement in accordance with HKSAE 3000 (Revised) and with reference to this PN. The auditor's report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI.The auditor's report shall state that the engagement was conducted in accordance with HKSAE 3000 (Revised) and with reference to PN 830 (Revised). The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor has to be submitted to the AI within two months from the date of the notification from the HKMA and the AI would forward the auditor's report together with any comments thereon. Prior consent from the HKMA may be sought for an extension of the deadline for submission, if there is good justification.

67. Examples of auditor's reports under section 63(3) are set out in Appendix 1 to this PN – Examples 1 and 2. An example of a modified auditor's report is set out in Appendix 8 to this PN – Example 1.

Auditor's report under section 63(3A)

General

68. It is the responsibility of an AI's directors and management to ensure that adequate systems of internal control are maintained. It is the responsibility of the HKMA to judge whether an AI has maintained adequate systems of internal control as part of its overall assessment as to whether all the criteria for authorization are being met.

69. As a supervisor, the HKMA is concerned with obtaining evidence to enable it to form a view as to whether the prudential requirements on internal control systems are met. The HKMA will do this, inter alia, by considering any evidence provided by the auditor.

70. The HKMA has interpreted the requirements of the Ordinance in various modules of its Supervisory Policy Manual. The auditor would need to be familiar with the contents of the guidance contained in these modules of Supervisory Policy Manual to the extent relevant to the specific examination requested by the HKMA.

71. The HKMA will require AIs to appoint the auditor to report to the directors of a locally incorporated AI or the chief executive of a Hong Kong branch of an overseas incorporated AI whether, in the auditor's opinion, certain internal control systems have been maintained by the AI throughout the period examined in accordance with the requirements of the Ordinance. In forming the opinion, the auditor would have regard, inter alia, to the nature and scale of the business of the AI. The auditor will also be required, after forming an opinion on the specified internal control systems, to report on other matters contained in section 63(3A)(b).

72. An engagement to express an opinion on an AI's systems of control for the purpose of the Ordinance differs in purpose and in scope from a study and evaluation of the systems made as part of an audit of financial statements in order to express an opinion on whether those statements give a true and fair view. Given these differences, the auditor is unlikely to be able to rely solely on the work carried out for the purpose of auditing the financial statements

and therefore the auditor would adopt additional procedures for the purpose of reporting under section 63(3A).

73. The scope and period to be covered by the report under section 63(3A) will normally be notified in writing to the AI and copied to the auditor.

Scope

74. The work that the auditor performs for the purpose of reporting under section 63(3A)(a) is an engagement providing reasonable assurance. The responsibility for adequate internal controls rests with the directors and management of the AI and the auditor's responsibility in providing reasonable assurance is to report on whether certain internal controls were in place during the relevant period. Having performed the work, the auditor is then required to report under section 63(3A)(b) on whether the auditor is aware of any material contraventions of certain provisions under the Ordinance by the AI and in addition, for locally incorporated AIs, any failure to maintain adequate provision. This aspect of the engagement is providing limited assurance and is based not only on the work performed under section 63(3A)(a) but also any other relevant information which comes to the attention of the auditor in the normal course of the audit work or in the examination of returns under section 63(3). The auditor will not, however, be expected to change the scope of the audit work nor the frequency or timing of the audit visits. Reference should be made to HKSAE 3000 (Revised) for details on the standards and guidance in this regard.

75. The HKMA is empowered under section 63(3A)(a) to require an AI to submit a report by the auditor on whether, during a specified period, the internal control systems of the AI were adequate to enable, as much as is practicable:

a. the AI's returns or information to be correctly compiled, in all material respects, from the books and records of the AI;

b. the AI to comply with its duties under Parts XII, XV, XVIA (for locally incorporated AIs only) and XVIB of the Ordinance;

c. in the case of a locally incorporated AI, the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

76. Having completed the work on the specified internal controls, the auditor would then report under section 63(3A)(b) in respect of the same period on whether:

a. there appears to be any material contravention by the AI of any of its duties under Parts XII, XV, XVIA (for locally incorporated AIs only) and XVIB of the Ordinance, and, if it so appears, the nature of the contravention and the evidence therefor; and

b. in the case of a locally incorporated AI, there appears to have been any failure by the AI to maintain adequate provision.

77. The period covered by a report under section 63(3A) will not normally be more than 12 months unless the HKMA is of the view that a longer period is necessary in the interest of depositors or the public. Usually the period covered will be the financial year. Only one report is required to be submitted under section 63(3A).

Nature of work

78. The nature of the work to be carried out will be to determine whether appropriate internal controls exist and test the effective functioning of such internal controls. Testing would, therefore, be designed to determine whether the control procedures are being performed effectively. It should also be noted that the adequacy of controls would be assessed with reference to Supervisory Policy Manual and guidelines issued by the HKMA and taking into

account the nature of business and size of the operation of the AI. For example, if the control being tested was the application of appropriate provisioning levels, the tests of the control may include:

- enquiry of the relevant officer and the supervisor/reviewer to ensure they clearly understand the objective of performing the control procedure;
- examination of the AI's provisioning policies, procedures and methodologies;
- assessment of whether the process of determining the level of provision has adhered to the policies, procedures and methodologies;
- examination of the process to obtain the necessary approvals;
- re-performance of the calculation or carrying out appropriate estimations on the provision amount; and
- checking that the provision amount has been properly recorded in the books and records of the AI.

Examples of procedures that the auditor may have regard to in assessing adequacy of controls are set out in the HKMA's Supervisory Policy Manual IC-3[7], Annexes A to C.

79. The auditor would also consider carefully the implications of any examinations performed by the HKMA, internal audit of an AI or other parties on an AI's internal control systems or asset quality. A material finding arising from such an examination can be an indicator of potential issues with the control systems in place and which may form the basis of an exception to be reported under section 63(3A). Nevertheless, auditors should be aware of the differences in scope and focus of these examinations in their deliberation.

Controls over compilation of returns and information from books and records

80. The auditor's work in testing the compilation process can be viewed or conducted in conjunction with the work done on specific returns under section 63(3). AIs regularly submit information to the HKMA for statistical and prudential supervision purposes. However, the work performed under section 63(3) is, in practice, only limited to a few key returns in a particular period. Consequently, the HKMA is seeking to gain additional comfort on the reliability of the information submitted in other returns throughout the year by way of an examination of the controls over the return compilation process of an AI.

81. The HKMA has set out in its Supervisory Policy Manual that AIs should have adequate systems of control to enable the submission of reliable statistics and information to it. The auditor is required under section 63(3A)(a)(i) to report on the effectiveness of the systems of control set up to ensure the correct transfer of information from records to returns. The HKMA expects that statistics and information would be complete, accurate and prepared in accordance with completion instructions issued by the HKMA. While there is no requirement for the auditor to opine on the AI’s books and records under section 63(3A), the auditor should remain professionally skeptical and stay vigilant to matters concerning the quality of the AIs’ books and records identified during the course of its work that may impact the banking returns and other information submitted by the AI to the HKMA. In this connection, the auditor should exercise judgement in determining the controls that fall into the scope of reporting under section 63(3A)(a)(i) according to the specific circumstances of individual AI. It should also be noted that the systems of control would cover not only periodic returns submitted to the HKMA but also other information such as ad hoc surveys

7 As at the date of issuing this revised PN, the HKMA’s Supervisory Policy Manual IC-3 is undergoing revision.

and statistics that the HKMA may request from an AI from time to time under section 63(2). The controls expected to be in place and the type of work that could be undertaken to enable the auditor to report on the effectiveness of controls would include the following:

a. *Controls over data capture for compilation of returns*

- AIs have controls in place to ensure that data that is necessary to enable reporting of information to the HKMA is captured completely and accurately, including controls over the data and information from the AI's overseas branches and/or its non-bank subsidiaries that are within the scope of regulatory consolidation where such data and information are material to the group. In most circumstances, reporting to the HKMA would be based on a set of predefined criteria and format. As such, it is important that adequate guidance on data definitions and the data capturing process are made available to responsible personnel so that they acquire a proper understanding of the requirements for data capture.

- The auditor would perform procedures to assess whether the relevant officers have an appropriate level of understanding of the reporting requirements taking into account the adequacy of guidance available for the purpose of capturing such information

- In situations where the AI has revised the returns and filed them with the HKMA, the nature and extent of changes made between the originally submitted returns and the Relevant Returns, may provide an indication of the strength or weakness of the controls over the compilation of returns. The auditor should take these into account in assessing the effectiveness of such controls.

b. *Understanding of the return compilation process and requirements*

- Persons responsible for compilation of returns from the AI's books and records should have an adequate understanding of the regulatory requirements and definitions set out by the HKMA in the relevant completion instructions and how they should be applied in the context of the AI's business and operations. The existence of a procedures manual that documents the relevant compilation processes at an appropriate level of detail provides a reference to officers responsible for the compilation process of the procedures that are to be carried out in compiling returns and information. Such a procedures manual would set out the timing of reports, compilation procedures, source of information, and other procedures carried out to collect information to ensure complete, accurate and timely compilation of returns and other information. The procedures manual should contain details that are consistent with guidelines, instructions from the HKMA and relevant correspondence between the AI and the HKMA which relate to compilation of returns and information.

- A comprehensive and quality procedure manual is indicative of management demonstrating an adequate understanding of the relevant reporting requirements and the controls necessary to ensure proper compilation of returns and information from books and records. The auditor should evaluate the adequacy of such a procedure manual as part of understanding an AI's controls in relation to the compilation process.

- The reporting requirements as set out in banking returns completion instructions can be complex and many aspects of the requirements are subject to proper interpretation. For certain specialist areas the auditor may need to consider engaging relevant subject matter experts (e.g. financial risk and valuation experts) to assist in assessing the appropriateness of an AI's interpretation and application of relevant completion instructions.

- The auditor would consider the adequacy of the processes and information in place to ensure that this understanding is updated for changes in regulatory reporting requirements as well as changes in business or operations. The auditor would also check the documentation of the control systems, and clarify the understanding of the systems with management to confirm the systems operate in the manner documented. The auditor is generally expected to perform tests on the effectiveness of these control systems and evaluate whether the governance framework as well as the roles and responsibilities with regard to compilation of banking returns are properly defined, documented and executed by the AI.

c. *Maintenance of adequate audit trail*

- AIs maintain clear, concise and organized documentation supporting the compilation of returns and other information from the relevant books and records so that there is a clear and traceable link between the underlying records and the completed returns.

- The auditor would carry out procedures to examine such documentation and perform tests as to whether the information contained in the completed returns and other information are compiled from the underlying books and records and seek appropriate explanations on any material exceptions or discrepancies thereon from management.

- If a Relevant Return has been revised, the auditor should obtain a reconciliation of adjustments between the originally submitted return and the Relevant Return from management. Such a reconciliation should contain the information as set out in Part A of Appendix 9 of this PN. Obtaining an understanding of the nature of the reconciling items and the reasons for such adjustments for the purpose of determining whether additional work procedures, based on the auditor's judgement, would be necessary for the planning of the engagement.

d. *Process for clarifying issues*

- AIs have in place a process whereby questions and issues (e.g. treatment of particular transactions for reporting purposes) that may arise in the course of compiling returns are identified and resolved in an appropriate manner. Such a process would include escalating the issue to appropriate personnel within the AI and where necessary, referred to the HKMA for clarification. All such clarifications would be properly documented and maintained for future reference purposes.

- The auditor would assess any material issues raised and be satisfied that the manner in which such issues were resolved was appropriate and in accordance with the relevant reporting requirements.

e. *Review and approval*

- Both the Chief Executive and the Chief Accountant or their equivalents are required to sign off on the returns submitted to the HKMA. The sign-off process is supported by adequate review and approval procedures during the course of the compilation. The purpose of such a review and approval process is to enable errors or inconsistencies to be identified and allow corrections to be made prior to the submission of the information to the HKMA. The review and approval procedures are performed by an officer independent of the preparation process and with an appropriate level of understanding of the requirements and how they are applied to the business and operations of the AI.

- The auditor would appraise the review and approval procedures as well as the experience of those responsible for such reviews and assess the adequacy and effectiveness of these procedures by way of observation, re-performance, or inquiry with relevant personnel.

f. *Use of computer-based tools and systems*

- The use of computer-based systems to facilitate the compilation of returns and other information from books and records of an AI is also increasingly common. Where AIs operate computer-based tools or systems to facilitate or automate the compilation of returns and other information, the auditor would consider relevant procedures to ensure the reliability of outputs generated from such computer-based tools or systems. These procedures may include assessing the adequacy of relevant controls (such as system production and change management controls, access security controls, end-user computing tools management controls and system backup management controls) over such tools or systems, or validating the data extraction performed by such tools or systems with the reporting requirements set out in the relevant rules and completion instructions, as appropriate. The auditor may also consider involving relevant IT experts in supporting the performance of the above procedures as circumstances warrant.

- In the event where the computer-based tools or systems to process information used for compiling returns and other information are not maintained by the AI (e.g. an AI may be a branch of an overseas incorporated bank which relies on the computer-based tools or systems developed and maintained by its head office), the auditor should perform relevant procedures to ensure the reliability of outputs generated from such computer-based tools or systems. These may include evaluating the user acceptance tests conducted before the launch or update of the systems or tools, reviewing issues/incidents log in relation to such systems or tools and reviewing rectification of issues/incidents relevant to the accuracy and completeness of information reported in the banking returns that may indicate any reliability issues with such systems or tools, or validating the data extraction performed by such tools or systems with the reporting requirements set out in the relevant rules and completion instructions, as appropriate.

g. *Backup arrangements*

- Staff changes can arise due to various reasons including planned and unplanned leave, rotation of duties, resignations, etc. AIs would have in place procedures to ensure that staff changes do not have any adverse impact on the quality of returns and other information or on the timing of their submission to the HKMA.

- The auditor would understand the AI's backup arrangements and assess whether backup staff responsible for compiling returns and other information have an adequate understanding of the requirements and procedures to be carried out.

Compliance with specific provisions of the Ordinance

82. The guidelines issued by the HKMA require AIs to have effective monitoring and reporting systems to enable compliance with their statutory duties under the Ordinance at all times. While this is a general principle which applies to all duties under the Ordinance, the auditor will be asked particularly to report on those controls relevant to the duties under Parts XII, XV, XVIA (for locally incorporated AIs only) and XVIB (section 63(3A)(a)(ii)) of the Ordinance. To meet this reporting requirement, the auditor would identify whether appropriate control procedures are in place to enable the AI to comply with its statutory duties under Parts XII, XV, XVIA (for locally incorporated AIs only) and XVIB of the Ordinance and test whether such control procedures, including controls over the data and information from the AI’s overseas branches and/or its non-bank subsidiaries that are within the scope of regulatory consolidation where such data and information are material to the group, are operating effectively.

83. The types of controls that AIs normally have in place to enable compliance with their statutory duties under the Ordinance at all times include:

- Procedures to ensure that management is fully aware of the relevant statutory provisions and regulatory requirements as they apply to the AI's operations;

- A repository of information containing the Ordinance, guidelines and circulars issued by the HKMA, communications with the HKMA and any amendments to all such documents is maintained, and procedures to ensure effective communication of such information to relevant personnel in the AI;

- Formal policies on compliance with the provisions of the Ordinance;

- Procedures on ensuring compliance with statutory and regulatory requirements in all aspects of the AI's operations are maintained. Such procedures may include setting of appropriate limits and targets, monitoring and reporting transactions against limits and targets, stress testing, etc. These procedures would deal not only with day-to-day operations but also the process of introducing new products and businesses;

- An officer (such as a compliance officer) designated with the responsibility for monitoring and ensuring compliance with statutory and regulatory requirements;

- Reports on compliance with statutory and regulatory requirements are produced and reviewed by relevant members of management (including the compliance officer) and actions on non-compliance are taken in a timely manner;

- Procedures for reporting any compliance failure to the HKMA in a timely manner are established;

- The monitoring of compliance is supported and evidenced by clear, concise and organized documentation to provide an audit trail for subsequent verification.

84. Part XII of the Ordinance deals with the requirements to disclose information to the HKMA, and the auditor's reporting responsibilities in this regard are addressed in the work on examining the AI's control systems for the correct compilation of returns or information from the books and records.

85. A report for the purpose of section 63(3A) also requires the auditor to conclude on whether adequate controls are in place to enable compliance with the following provisions of the Ordinance:

- Part XV – Limitations on exposures and interests of AIs

- Part XVIA – Capital requirements (for locally incorporated AIs only)

- Part XVIB – Liquidity requirements

86. The types of controls which are normally in place in the AI to enable compliance with the above provisions and which the auditor would take into account in designing the procedures include:

a. *Part XV – Limitations on exposures and interests of AIs*

- Written policy in respect of taking of own shares as security, large exposures and advances to connected parties, equity exposures and interests in land;

- Establishment of appropriate internal limits (within the statutory limits under the Ordinance and limits under the Banking (Exposure Limits) Rules ("BELR") for individual customers and groups of related customers, equity exposures and interests in land and sub-limits for various business units, branches or subsidiaries; *(With effect from 13 July 2018, section 87 on limitation on shareholding by authorized institutions* *was repealed. The BELR on equity exposures have come into effect on 13 July 2018. Please refer to BELR for the details of requirements.)*

- Process for identifying and reporting breaches against internal limits to senior management on a continuing basis;

- Timely reporting of positions and exposures to management to enable appropriate actions to be taken;

- A system to capture all up-to-date financial exposures to a particular customer or group of related customers, irrespective of whether they are exempted or not;

- Procedures to ensure that compliance checks are performed prior to approval of facilities;

- Procedures to enable the terms and conditions for exemptions granted by the HKMA on exempted exposures to be monitored and complied with on an ongoing basis.

b. *Part XVIA – Capital requirements (for locally incorporated AIs only)*

- Written policy on the AI's strategy on maintaining capital adequacy and leverage ratio requirement for the purpose of both its business activities and to meet regulatory requirements;

- Establishment of target capital ratios and leverage ratio which are above the minimum required for business or regulatory purposes;

- Process for identifying and reporting breaches against target ratios to senior management on a continuing basis;

- Budgets prepared to take into account capital adequacy and leverage ratio requirements and changes in capital adequacy and leverage ratio requirement as a result of projected asset mix, balance sheet growth and capital resources;

- Capital adequacy ratios, Net CET1 capital ratio and buffer level, and leverage ratio are calculated and reported to management on an ongoing basis;

- Procedures on assessing impact of large loans, investments or other significant transactions on capital adequacy and leverage ratio requirement prior to the transaction taking place;

- Stress-tests are performed on capital adequacy ratio on a regular basis.

c. *Part XVIB – Liquidity requirements*

- Written policy on the AI's strategy and procedures for maintaining adequate liquidity at all times to meet business and regulatory requirements;

- Category 1 institutions should have systems and procedures in place to:

  - ensure on an ongoing basis that the assets included as high quality liquid assets ("HQLAs") for the purpose of calculating the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR") satisfy all requirements relating to asset class, characteristics and operational requirements as specified in Schedules 2 to 4, where applicable of the Banking (Liquidity) Rules;

  - manage its HQLAs and related risks (including foreign exchange risk and concentration risk) on an ongoing basis;

- ensure proper review and application of established methodologies (including key management assumptions) in determining the amounts of certain expected cash flow items (such as "operational deposits", potential drawdown on undrawn committed facilities and non-contractual contingent funding obligations) for the calculation of LCR and NSFR;

- Category 2 institutions should have systems and procedures in place to:

  - conduct ongoing assessment and management of its liquefiable assets and related risks to ensure each asset included in the liquefiable assets and satisfies all the applicable requirements of Part 8 of the Banking (Liquidity) Rules; and

  - conduct ongoing assessment and management of its Core Funding Ratio ("CFR") and related risks introduced in liquidity regulations in January 2018 applicable to AIs designated by the HKMA as "category 2A institutions" in accordance with Rule 3A of the Banking (Liquidity) Rules.

- Systems, controls and procedures are in place to ensure that the valuation of any asset, liability, off-balance sheet item or cash flow measured at fair value is prudent and reliable for the purposes of calculating the LCR or Liquidity Maintenance Ratio ("LMR"), and NSFR or CFR (as applicable);

- Target ratios for liquidity which are above the minimum regulatory requirements are set (i.e. the liquidity requirements of LCR (or LMR) and NSFR (or CFR) under rule 4 (or rule 7) and rule 8A (or rule 8D) of the Banking (Liquidity) Rules respectively) for different categories of institutions and procedures are in place to identify and immediately report breaches or exceptions to senior management;

- Procedures are in place to allow liquidity ratios to be reported and monitored on an ongoing basis;

- Procedures on assessing impact of large loans, investments or other significant transactions on liquidity prior to the transaction taking place;

- Contingency plans are in place for coping with various types of liquidity crisis;

- Stress-tests are performed on the liquidity position on a regular basis.

87. A checklist of questions concerning compliance with Part XII, XV, XVIA or XVIB of the Ordinance is set out in Appendix 7 to this PN.

88. Other procedures that the auditor may consider in assessing controls to ensure compliance with Parts XV, XVIA and XVIB are set out in the HKMA's Supervisory Policy Manual IC-3[8], Annex B.

Maintenance of adequate provision

89. For locally incorporated AIs only, the auditor is required to report on whether or not, during the period, the AI had in place systems of control which were adequate to enable it, as much as is practicable, to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur, and if those systems were not adequate the nature and extent of those inadequacies.

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8 As at the date of issuing this revised PN, the HKMA’s Supervisory Policy Manual IC-3 is undergoing revision.

90. Maintenance of adequate provision is one of the key criteria for maintaining an authorization and for many AIs, an area of particular focus by management. The HKMA has also issued guidelines on loan classification and provisioning requiring AIs to have adequate policies and procedures for the regular appraisal of the quality of their assets and for the establishment of adequate provision for bad and doubtful debts.

91. The auditor, as part of the statutory audit may have performed certain procedures relating to the maintenance of adequate provision and the work required to comply with the statutory reporting duties under this section may be an extension of the work performed for statutory audit purposes.

92. The types of controls AIs would normally maintain to ensure that they meet the objective of maintaining adequate provision in accordance with the Hong Kong Financial Reporting Standards and, if any, the additional requirements from the HKMA include:

- Written policies and procedures setting out the frequency of review, methodology and level of provision to be maintained for each class of exposure (e.g. on- and off-balance sheet);

- An appropriate loan classification system with clear definitions (both qualitative and quantitative measures) for each class of exposures to allow monitoring of asset quality on a regular basis;

- Minimum provision levels are set and observed for each class in the classification system;

- Responsibilities for reviewing and approving provision are clearly allocated to officers or committees with sufficient authority;

- The credit process includes procedures for:

  - monitoring of asset quality and concentration risks by country and sector;
  - monitoring of adverse economic or political factors which may have an effect on asset quality or borrowers' repayment ability;
  - monitoring of overdue, rescheduled or over-limit assets;
  - reviewing irregularities in individual credit exposures;
  - reviewing the borrowers' and guarantors' financial position;
  - reviewing and updating the value of collateral on a regular basis.

- Procedures are carried out to review and assess the level of provision on a regular basis;

- Provisioning decisions are recorded, documented and reported to senior management, an appropriate committee and to the Board on a regular basis;

- Procedures are carried out to review the value of assets on a regular basis (such as fixed assets, investments and other assets) to assess whether impairment or loss exists;

- Procedures are in place to identify and determine an appropriate level of provision for liabilities including assessments of whether contingent liabilities should be recognized as liabilities on the balance sheet (e.g. litigation cases).

Representations by management

93. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from management covering, inter alia, the following areas:

a. acknowledging management's responsibility for establishing and maintaining the systems of internal control and that the AI complies with the provisions of the Ordinance at all times;

b. stating that management has disclosed to the auditor all material weaknesses in the internal control systems of which it is aware and also those areas for which management believes the cost of corrective action may exceed the benefits;

c. stating that management has made available to the auditor all relevant information (e.g. records and documents, procedures manuals, instructions and correspondence with the HKMA, etc.) for the purpose of the auditor's examination of the internal control systems, additional information that the auditor requests from the AI for the purpose of the engagement, and unrestricted access to persons within the AI from whom the auditor determines it necessary to obtain audit evidence;

d. describing any irregularities involving management or employees who have significant roles in the systems of internal control;

e. stating whether there were any changes made subsequent to the reporting date which would significantly affect the systems of internal control, including any corrective action taken by management with regard to material weaknesses;

f. stating whether there have been communications between regulatory authorities and the AI concerning non-compliances with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which would have a material effect on the returns;

g. stating whether or not there have been contraventions by the AI of its duties under Part XII, XV, XVIA (for locally incorporated AIs only) or XVIB of the Ordinance during the relevant period;

h. for locally incorporated AIs only, confirming that the AI has maintained adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), and for actual or potential liabilities and losses during the relevant period;

i. for registered institutions, confirming that the AI has complied with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (see paragraphs 131 to 139);

j. confirming that management is not aware of any matters which would adversely affect the financial position of the AI to a material extent; and

k. management has read the draft auditor's report and confirms the factual accuracy of information and statements contained in the draft auditor's report.

94. An example management representation letter is set out in Appendix 2 to this PN – Example 2.

Materiality

95. An exception which would be reported for the purpose of a report under section 63(3A) would relate to either:

- a material weakness in controls over (i) compilation of returns and other information, (ii) compliance with certain provisions of the Ordinance, and (iii) maintenance of adequate provision;
- an actual contravention of the Ordinance; or
- inadequate provision.

96. The auditor would need to assess whether an exception identified from testing controls represents a control weakness or is a result of an isolated incident. The auditor should gather sufficient evidence to determine whether a control weakness exists and then proceed to assess whether such weakness is material.

97. The auditor exercises judgment on whether a weakness or failure in the control systems is material by evaluating the impact such a weakness or failure has on the banking returns or other information, the ability of the AI to comply with relevant provisions of the Ordinance and to maintain adequate provision. In respect of an overseas incorporated AI, it is a weakness or failure in the control systems which is material in the context of the AI's operations in Hong Kong which would be reported. The auditor should also consider whether or not the control weakness is pervasive. That is, whether it has led to, or in the future will likely result in, one or more material errors in the banking returns or other information.

98. Considerations on materiality in the context of reporting under section 63(3A) are wide ranging and vary depending on the nature, size and complexity of the AI concerned. Whilst an actual contravention of the Ordinance is generally a factual matter, what is considered to be material for the purpose of reporting on controls and adequacy of provision requires the exercise of judgment in the context of the AI concerned. The auditor would perform adequate procedures to confirm existence and effectiveness of controls on areas which, in the auditor's judgment, are material with respect to the AI.

99. The auditor would normally be required to report separately under section 63(3) on whether specific returns were compiled based on the AI's books and records. Errors (whether material or not) identified in the course of the auditor's work for the purpose of section 63(3) are prima facie evidence that there may be an internal control weakness in the compilation process. Therefore, the auditor would consider carefully the underlying reasons leading to such errors and assess the implications on the work under section 63(3A). A systematic error as well as numerous unrelated errors identified in respect of a specific return should provide an indication that weaknesses exist in the AI’s ability to measure and capture data and information from books and records correctly. Even if such errors are not material for reporting under section 63(3) of the Ordinance, they call into question the soundness of AI’s internal controls over regulatory reporting process and hence should be considered by the auditor for reporting under section 63(3A) of the Ordinance. The same consideration should be equally applied when the auditor evaluates other information reported to the HKMA by the AIs.

Reporting

100. The auditor's report under section 63(3A) is a report on both the existence of appropriate controls and whether such controls have operated effectively during the specified period. The opinion in the auditor's report under section 63(3A) is structured into two main parts. The first part is a reasonable assurance opinion for the purpose of section 63(3A)(a) on whether controls are in place to enable:

- the AI to correctly compile from its books and records, in all material respects, the returns and other information, which are required to be submitted to the HKMA;
- the AI to comply with its duties under Parts XII, XV, XVIA (for locally incorporated AIs only) and XVIB of the Ordinance; and
- the AI to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur (for locally incorporated AIs only).

The second part is a limited assurance opinion for the purpose of section 63(3A)(b) given on the basis of the work performed under section 63(3A)(a), on whether the auditor was aware of:

- any instances where the AI has materially contravened any of its duties under Part XII, XV, XVIA (for locally incorporated AIs only) or XVIB of the Ordinance; and
- for locally incorporated AIs, any instances where the AI has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

101. The opinion in respect of section 63(3A)(b) is drawn from the work performed under section 63(3A)(a). However, the HKMA would expect the auditor to take into account any other information which comes to the attention in the capacity as the auditor of the AI, including any information obtained from the normal course of any audit work performed and in the auditor's examination of specific returns under section 63(3).

102. An appropriate description of any weakness or failure in the control systems considered to be material would be reported together with the auditor's recommendations for improvement where possible. In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised), Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised). In the event that observations are identified in relation to AI's control systems during the course of auditor's work but do not result in modification of the auditor's report under section 63(3A) of the Ordinance, the auditor may consider communicating these control observations to AI's management and those charged with governance as the auditor deems appropriate.

103. The auditor should carry out an engagement in accordance with HKSAE 3000 (Revised) and with reference to this PN. The auditor's report would be addressed to the directors in the case of a locally incorporated AI, and to the chief executive in the case of a Hong Kong branch of an overseas incorporated AI. The auditor's report shall state that the engagement was conducted in accordance with HKSAE 3000 (Revised) and with reference to PN 830 (Revised). The auditor's report would be completed, dated and submitted to the AI. Normally, the report by the auditor has to be submitted to the AI within three months from the end of the specified period and the AI would forward the auditor's report together with any comments thereon within a further one month.

104. Examples of auditor's reports under section 63(3A) are set out in Appendix 1 to this PN – Examples 3 and 4. An example of a modified auditor's report is set out in Appendix 8 to this PN – Example 2.

Ad hoc reports under section 59(2)

General

105. The HKMA has discretionary power under section 59(2) to require an AI, after consultation with the AI, to provide an auditor's report on any matters the HKMA may specify which are relevant for the exercise of its functions. This power enables the HKMA to require an AI to appoint the auditor to report on internal controls, specific transactions, or any other matters which are relevant for the performance of its functions under the Ordinance.

106. A report under section 59(2) is commissioned on an ad hoc basis. The circumstances which can lead to a decision by the HKMA to commission such a report generally relate to the identification of issues or events which pose a significant adverse risk to the AI's financial position, business or operations, or represent a threat to the interest of depositors or stability of the banking sector. Such issues or events can arise from:

- significant internal control weaknesses raised in management letters from the AI's auditor;
- issues arising from reviews by the HKMA or internal auditors;
- frequent errors in returns submitted to the HKMA;
- occurrence of an adverse event (e.g. fraud) affecting the AI;
- significant exposures to certain high risk business activities.

107. As set out in the HKMA's Supervisory Policy Manual IC-3, the HKMA can also require a report to be commissioned on the financial affairs of the AI, based on an audit of its financial statements, if the HKMA has reason to believe that the normal audit carried out by the auditor was, or is likely to be, deficient.

108. The AI's statutory auditor may be appointed for the purposes of reporting under section 59(2). Even where there are no doubts about the capability of the statutory auditor, the HKMA has the right to require that a report under section 59(2) be obtained from another audit firm to obtain a fresh perspective on matters which are the subject of the report. The appointed auditor must also be able to meet the ethical and independence requirements set out by the internationally accepted ethical and independence standards (such as the Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants) and the additional requirements (if any) set out by the HKMA in relation to the relevant engagement before its formal acceptance of the appointment.

109. The extent of the detail included in the auditor's report concerning the description of the relevant internal controls and of the procedures undertaken to test the operation of those controls to support the conclusion provided is a matter of judgment for the auditor. The auditor would have regard to the expectations of the HKMA and the AI and would evaluate the risk of misinterpretation or misunderstanding in this regard.

110. The auditor would seek to ensure that the extent of the description of the relevant internal controls to be included in the report and the extent of the procedures to be undertaken is specified in the Letter of Instruction issued by the AI. Similar principles apply to any other engagement requiring the exercise of significant judgment.

Scope

111. Due to the fact that a section 59(2) report is commissioned on an ad hoc basis, the HKMA would consult with the AI and the auditor on the scope of work and agree in advance on the terms of reference prior to issuing a notification in writing to the AI requiring such a report.

112. During the discussion with the HKMA and the AI regarding the scope to be covered in the ad hoc review, the following factors would be taken into account:

- Exact scope (including any specific concern) that the HKMA would like to be covered in the ad hoc review;
- Agreed assurance and materiality level;
- Specific areas of concern that the HKMA would like the auditor to cover in the ad hoc review;
- Specific guidelines on format of deliverables, including level of assurance required from the auditor.

113. The period to be covered by a report under section 59(2) will vary depending on the circumstances, but the HKMA has indicated that it will not normally exceed 12 months. Factors to be taken into consideration in determining the period to be covered include whether:

- there is enough evidence of policies, controls and records available in the period (for example, whether relevant senior management meetings will have taken place); or
- changes are expected in the area(s) to be examined (for example in systems, processes, management or products). If so, the auditor would determine whether the auditor's report is intended to reflect the position before, after or during the change period.

114. In certain circumstances, the auditor might be unable to assess the proposed scope sufficiently without a greater understanding of the AI's operations in the area to be examined – for example the organizational structure, product profiles or volumes of transactions. This can arise where the auditor is not the AI's statutory auditor or the scope relates to an area that is not covered extensively by statutory audit work. In these circumstances, the auditor may wish to agree with the HKMA and the AI that a short initial visit to the AI be undertaken before the final scope of the work is agreed. This would enable the auditor to assist the HKMA in refining the scope more effectively.

115. Where applicable, the auditor would agree with the HKMA and the AI on which of the AI's legal entities, divisions, or businesses the report would cover. Depending on individual circumstances, the auditor would usually engage the HKMA in a formal discussion in the presence of the AI’s management (i.e. a tri-partite arrangement) to confirm expectations as to the scope, nature and extent of work to be performed prior to commencement of the section 59(2) engagement. In the event changes need to be made to scope, nature and extent of work subsequent to the commencement of engagement, such changes should be communicated and agreed with the AI and the HKMA on a timely basis .

116. The auditor's report would normally be submitted to the AI within a period of three months from the date of the notification letter issued by the HKMA and forwarded to the HKMA together with comments from the AI within a further month. The reporting deadline can be varied at the discretion of the HKMA to take into account special circumstances after consultation with the AI and the auditor concerned.

Nature of work

117. The work that the auditor performs for the purpose of reporting under section 59(2) would vary depending on the circumstances surrounding the commissioning of such a report and the subject matter. As such, the engagement can be a reasonable or limited assurance engagement or an engagement to perform agreed-upon procedures or others (e.g. review and comment engagement).

118. For reasonable or limited assurance engagement, the auditor should consider to conduct the work in accordance with HKSAE 3000 (Revised). The auditor would seek to develop and establish suitable criteria for the engagement based on specified modules of Supervisory Policy Manual or guidelines issued by the HKMA. The modules of Supervisory Policy Manual or guidelines issued by the HKMA used would be agreed in advance. The determination of whether the engagement provides reasonable assurance or limited assurance would depend on the level of assurance required in the circumstances of the engagement. For agreed-upon procedures engagement, the auditor should perform the engagement under HKSRS 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information".

119. Paragraph 118 only provides reference for the auditor and it is not served to limit the appointed auditor's professional judgment and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.

Materiality

120. Given the varying nature of ad hoc reviews under section 59(2), the auditor would ensure that clear reference points have been agreed with both the AI and the HKMA to determine the level of assurance that can be provided under given terms of reference. For some engagements, the terms of reference can be expressed in terms of one or more HKMA's and / or other requirements. Some terms of reference are highly specific, quantitative and objective and therefore readily capable of reliable and consistent measurement and interpretation. Some terms of reference are general, qualitative and highly subjective. Others may fall between these two extremes.

121. In order to assess fully the level of assurance that is appropriate concerning general, qualitative, subjective terms of reference, the auditor, where necessary, would assist the HKMA and the AI to prepare, a set of specifically developed criteria which are more capable of reliable and consistent measurement and interpretation in light of the requirements of the HKMA. In many cases, reference can be made to Supervisory Policy Manual and guidelines issued by the HKMA and other pronouncements which set out in sufficient detail the assessment criteria to support an assurance engagement. However, the HKMA remains responsible for determining whether the specifically developed criteria meet its purposes for commissioning a report.

Reporting

122. The auditor would consider whether it is necessary to provide in the report an introductory or background section to set in context the conclusion (or overall findings otherwise reported).

123. Such background information is relevant to the area examined in the report and can include, for example, a description of the organization in that area, the main business lines, the profile of the business and the market significance in the sector and the description of the procedures undertaken.

124. Detailed narrative reports are normally necessary in order to communicate properly the judgments made, the reasons underpinning those judgments and the context in which a conclusion is provided. The implications for the auditor are that a report covering internal controls includes, inter alia, comparatively detailed descriptions of:

- the elements of the design and operation (as applicable) of the internal control systems that are subject to evaluation; and

- the extent and nature of the procedures undertaken to gain assurance that the internal controls specified operate as prescribed (if part of the scope).

125. The description of the procedures undertaken includes, where appropriate, such matters as details of documents examined, persons interviewed and tests of detail performed.

126. The auditor would attach a copy of the engagement letter and the Letter of Instruction from the AI as appendices to the auditor's report.

127. An example of a report under section 59(2) is set out in Appendix 1 to this PN – Example 5.

Notification of audit qualifications or adverse statements under section 59A(2)(c)

128. Under section 59A(2)(c), the auditor of an AI appointed under section 395, 396, 397 or 398 of the Companies Ordinance is required to provide written notice to the HKMA if the auditor decides to include in the audit report on the AI's financial statements any qualification or adverse statement as to a matter mentioned in section 406 or 407 of the Companies Ordinance.

129. The issue of a qualified audit report or an adverse statement in relation to a matter under section 406 or 407 of the Companies Ordinance may have a potentially significant impact on the AI concerned and have to be communicated to the HKMA as soon as reasonably practicable. Except for matters required to be reported under sections 63A and 63B, the auditor would normally be expected to discuss with the AI any matter about which the auditor is concerned, and request that the AI draws the matter to the attention of the HKMA. Nevertheless, it is important for the auditor to strike a balance between preserving the professional relationship with the AI, the possible impact on depositors' interests arising from a delay in reporting and the need to take appropriate legal advice in deciding whether to report such an issue via the AI or directly to the HKMA. In relation to a qualification or an adverse statement, the auditor would take into account the severity of the matter as well as the AI's response to the auditor's request to communicate the matter to the HKMA.

130. In the HKMA's Supervisory Policy Manual IC-3, the HKMA has set out examples of the circumstances where it believes management of the AI should not be informed in advance in the interest of protecting depositors and the auditor should report directly to the HKMA after considering appropriate independent legal advice. The auditor would make reference to these examples in assessing the circumstances surrounding the qualification of the audit report on an AI's financial statements or an adverse statement in connection with a matter under section 406 or 407 of the Companies Ordinance.

Reporting of significant adverse matters and non-compliances under sections 63A and 63B

131. Sections 63A and 63B require AI's auditor to submit a report to the HKMA if the auditor becomes aware of any matter in the course of performing the duties as the auditor that in the auditor's opinion:

- adversely affects an AI's financial position to a material extent (section 63A); or
- constitutes on the part of an AI that is a registered institution under the Securities and Futures Ordinance ("SFO") a failure to comply with certain provisions or rules made under the SFO (section 63B).

132. Matters which are required to be reported under sections 63A and 63B have to be reported by the auditor in writing directly to the HKMA as soon as is reasonably practicable. There is no specified format for such a report but the report would cover the nature of the matter and the reasons why the auditor is of the opinion that the matter should be reported.

133. Section 63A requires the auditor which is appointed under section 59(2), 63(3) or 63(3A) of the Ordinance or section 395, 396, 397 or 398 of the Companies Ordinance to report to the HKMA if the auditor becomes aware of a matter which, in the auditor's opinion, adversely affects the financial position of an AI to a material extent. The auditor would consider any such matter which comes to the auditor's attention in the context of the AI as a whole. In relation to an overseas incorporated AI, the requirement of section 63A applies to its principal place of business in Hong Kong and its local branches and as if the principal place of business in Hong Kong and those branches were collectively a separate AI.

134. Some of the matters which the HKMA would expect to be reported under section 63A include the following:

- whether the AI's status as a going concern is questionable (e.g. a material loss that may threaten the financial condition of the AI);
- whether the AI's capital adequacy ratio has dropped, or will drop, significantly to a level which may be detrimental to depositors;
- whether the liquidity position of the AI has deteriorated or will deteriorate to a level which is likely to threaten the interests of depositors.

135. As matters which are reportable under section 63A relate to the financial position of AIs, the auditor is expected to take into consideration potential issues that may constitute a reportable matter under this section in the course of performing the work on AI's financial statements or for the purpose of reporting under section 59(2), 63(3) or 63(3A).

136. Under section 63B, when the auditor becomes aware of a matter that, in the auditor's opinion, is a matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the SFO (a "reportable matter"), the auditor shall, as soon as practicable after the auditor becomes aware of the matter, submit to the HKMA a report in writing on the matter.

137. A reportable matter in respect of AIs refers to a matter that, in the auditor's opinion, constitutes on the part of the AI a failure to comply with any prescribed requirement. Prescribed requirement refers to the requirements of any rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO. However, it should be noted that section 63B specifically excludes the requirements under section 149 of SFO in relation to holding of client monies.

138. The HKMA has recognized that there is no obligation for the auditor to specifically perform work or to change the scope, nature and depth of the work to identify non-compliance with the requirements of the SFO where such work does not already form part of the procedures carried out for the purpose of an audit on the AI's financial statements, or for the purpose of reporting under section 59(2), 63(3) or 63(3A). Therefore the auditor is not required to actively seek out grounds for making a report under section 63B and it is only when the auditor becomes aware, in the ordinary course of the work, of a reportable matter that the auditor would make a report to the HKMA.

139. A summary of the relevant regulations and requirements issued by the SFC that the auditor would have to be familiar with for the purpose of understanding and fulfilling the duties under section 63B is set out in Appendix 6 to this PN.

Notification of resignation of the auditor under section 59A(2)

140. Section 59A(2) requires the auditor of AIs appointed under section 395, 396, 397 or 398 of the Companies Ordinance to provide written notice to the HKMA if the auditor resigns before the expiration of the term of office (section 59A(2)(a)) or if the auditor does not seek to be re-appointed (section 59A(2)(b)). Such a written notice is required to be provided to the HKMA immediately.

Report of factual findings in relation to voluntary revocation of authorization

141. In an application for voluntary revocation of the authorization of an AI, the HKMA would require the AI to furnish a report by its auditor in respect of the balance sheet, third party deposit liabilities, contingent liabilities and outstanding commitments. This report would help satisfy the HKMA that the interests of the AI's depositors are or will be adequately safeguarded when the AI's authorization is revoked. The HKMA may provide a copy of the report to the Financial Secretary of the Hong Kong Special Administrative Region Government for the purpose of section 22(1).

142. A report by the auditor of factual findings in relation to a voluntary revocation of the authorization of an AI is an agreed-upon procedures engagement. As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work. Reference would be made to HKSRS 4400 for details on the standards and guidance in this regard. An example engagement letter for a report of factual findings in relation to voluntary revocation of authorization is set out in Appendix 3 to this PN – Example 3.

143. The report of factual findings by the auditor is prepared based on specified procedures which would include the following matters:

a. Whether the AI had any outstanding third party deposit liabilities according to the general ledger and customer deposit records of the AI as at a specified date, and whether this is consistent with the information in the management representation letter;

b. Whether the balance sheet as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the management representation letter; and

c. Whether the summary of contingent liabilities and outstanding commitments as at a specified date was in agreement with the AI's books and records, and whether it is consistent with the information in the board minutes and the management representation letter.

144. The auditor would follow the guidance in HKSA 580, "Written Representations" and obtain a letter of representation from director (or management) confirming, inter alia, the following areas as at the specified date for the purpose of the report:

a. the accuracy and completeness of third party deposit liabilities of the AI;

b. the balance sheet was in agreement with the AI's books and records; and

c. the accuracy and completeness of contingent liabilities and outstanding commitments.

145. An example management representation letter is set out in Appendix 2 to this PN – Example 3.

146. The report of factual findings is prepared in accordance with HKSRS 4400. A copy of the balance sheet of the AI and a summary of contingent liabilities and outstanding commitments (or a nil report if there are no contingent liabilities and outstanding commitments) as at the specified date would be attached to the report. An example of the report is set out in Appendix 1 to this PN – Example 6.

PART III – PROTECTION FOR THE AUDITOR ON COMMUNICATIONS WITH THE HKMA

147. Section 61 permits the auditor, notwithstanding any duty which the auditor may owe to the clients (e.g. confidentiality), to communicate to the HKMA, provided that:

- the communication, whether or not in response to a request by the HKMA, is in good faith; and

- the information so disclosed relates to information or opinion on a matter of which the auditor becomes aware in the capacity of the auditor and which is relevant to any function of the HKMA under the Ordinance.

148. The protection covers not only the auditor appointed under section 395, 396, 397 or 398 of the Companies Ordinance but also the auditor appointed for the purpose of sections 50(1)(c), 59(2), 63(3) and 63(3A). It also covers the auditor who makes a report to the HKMA under sections 63A and 63B.

149. The protection afforded by section 61 is general and not restricted by the circumstances in which the information is obtained or by its sources. Provided the information becomes known to the auditor in the capacity as the auditor of an AI, they may communicate that information to the HKMA notwithstanding that:

- the information does not relate to the auditing work undertaken by the auditor; or

- the source of the information was not the AI.

150. Section 61 does not of itself require the auditor to change the scope, nature and depth of the audit work and the auditor is not required to actively seek out grounds for making a report under this section.

151. Appendix 4 to this PN contains further guidance on ad hoc reports under section 61 that has been prepared to assist the auditor in understanding the circumstances in which the auditor would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61. Section 61 does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.

EFFECTIVE DATE AND TRANSITION

152. Effective for reporting periods ending on or after 1 January 2019.

153. Auditor’s reports for reporting periods ending before the above-mentioned effective date should continue to be prepared with reference to the guidance set out in the previous version of this PN.

APPENDIX 1
Examples of reports by the auditor

Example 1 – Section 63(3) report for locally incorporated AIs

INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3) OF THE BANKING ORDINANCE

To the Directors of XYZ Bank

Pursuant to section 63(3) of the Banking Ordinance (the "Ordinance"), we have been requested to report on whether certain returns of XYZ Bank (the "Institution") as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns ("Returns") and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

i. Return of Capital Adequacy Ratio of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* as at [*date*];

ii. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [*date*];

iii. Return of Liquidity Position of the [*Institution and all its subsidiaries*]* [*Institution and certain of its subsidiaries set out below*]* [*Institution and its subsidiaries other than those set out below*]* [*Institution on a consolidated basis*]* [*Institution on an unconsolidated basis*]* [*Institution's offices in Hong Kong*]* for the month of [*month/year*]; and

iv. Parts I - IV of the Certificate of Compliance of the Institution [*and all its subsidiaries*]* [*and certain of its subsidiaries set out below*]* [*and its subsidiaries other than those set out below*]* [*on a consolidated basis*]* for the quarter ended [*date*].

[The subsidiaries referred to in i., ii., iii. and iv. above are as follows:]*

Directors' Responsibilities

As the directors of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1[9] and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

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

Auditor's Responsibilities

Our responsibility is to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us.[10] These procedures do not represent an audit of the books and records of the Institution.

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

We have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised), which included examining evidence obtained from the Institution regarding the Institution's compilation of banking returns and other information.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Intended Users and Purpose

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
[*Auditor's Address*]
[*Date*]

* Delete where not applicable

[10] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

Example 2 – Section 63(3) report for local branch(es) of overseas incorporated AIs

INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3) OF THE BANKING ORDINANCE

To the Chief Executive of the Hong Kong Branch(es) of XYZ Bank

Pursuant to section 63(3) of the Banking Ordinance (the "Ordinance"), we have been requested to report on whether certain returns of XYZ Bank's Hong Kong Branch(es) (the "Institution") as set out below are correctly compiled, in all material respects, from the books and records of the Institution in accordance with the completion instructions issued by the Monetary Authority.

Scope

This report covers the following attached returns ("Returns") and does not extend to any other return or information submitted to the Monetary Authority by the Institution:

i. Parts I, II and III, columns 1 - 5 of the Return of Large Exposures of the Institution for the quarter ended [*date*];

ii. Return of Liquidity Position of the Institution for the month of [*month/year*]; and

iii. The Certificate of Compliance of the Institution for the quarter ended [*date*].

Chief Executive's Responsibilities

As the chief executive of the Institution, you are responsible for ensuring the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1 [11] and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Auditor's Responsibilities

Our responsibility is to report on whether the Returns are correctly compiled, in all material respects, from the books and records of the Institution, and if not so correctly compiled, the nature and extent of the incorrectness, based on the results of the procedures performed by us.[12] These procedures do not represent an audit of the books and records of the Institution.

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

[12] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance on whether the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

We have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised), which included examining evidence obtained from the Institution regarding the Institution's compilation of banking returns and other information.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

Based on the foregoing, in our opinion, the Returns have been correctly compiled, in all material respects, from the books and records of the Institution.

Intended Users and Purpose

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
[*Auditor's Address*]
[*Date*]

Example 3 – Section 63(3A) report for locally incorporated AIs

INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3A) OF THE BANKING ORDINANCE

To the Directors of XYZ Bank

Pursuant to section 63(3A) of the Banking Ordinance (the "Ordinance"), we have been requested to report on whether or not, during the period from [*date*] to [*date*] (the "relevant period") XYZ Bank (the "Institution") had in place systems of control which were adequate to enable, as much as is practicable:

i. the Institution's returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;

ii. the Institution to comply with its duties under Parts XII, XV, XVIA and XVIB of the Ordinance;

iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur

in accordance with the requirements specified in Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance" ("SPM IC-3") issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period:

i. there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV, XVIA and XVIB of the Ordinance;

ii. it appears that the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

Directors' Responsibilities

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

i. the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;

ii. the Institution to comply with its duties under Parts XII, XV, XVIA and XVIB of the Ordinance;

iii. the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1 [13] and accordingly maintains a

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

comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Auditor's Responsibilities

Our responsibility is to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.[14]

We conducted our engagement for the examination of relevant internal control systems in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance for giving conclusion 1 and obtain limited assurance for giving conclusion 2 below.

In respect of our examination of relevant internal control systems for conclusion 1 below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

In respect of conclusion 2 below, we have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised).The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

Inherent Limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1.* in our opinion, in all material respects, during the relevant period, the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and

2. during the relevant period,

   i. we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVIA or XVIB of the Ordinance;

[14] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

ii. we are not aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

Intended Users and Purpose

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
[*Auditor's Address*]
[*Date*]

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* *For the conclusion section (1), the above example would be adopted for the situation where the auditor has no reservations about the institution's systems of internal control [an unqualified opinion]. Example modified conclusions are set out in Appendix 8 to this Practice Note.*

Example 4 – Section 63(3A) report for local branch(es) of overseas incorporated AIs

INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 63(3A) OF THE BANKING ORDINANCE

To the Chief Executive of the Hong Kong Branch(es) of XYZ Bank

Pursuant to section 63(3A) of the Banking Ordinance (the "Ordinance"), we have been requested to report on whether or not, during the period from [*date*] to [*date*] (the "relevant period") XYZ Bank's Hong Kong Branch(es) (the "Institution") had in place systems of control which were adequate to enable, as much as is practicable:

i. the Institution's returns or information submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the Institution;

ii. the Institution to comply with its duties under Parts XII, XV and XVIB of the Ordinance

in accordance with the requirements specified in Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance" ("SPM IC-3") issued by the Monetary Authority.

In addition, we have been requested to report whether or not, during the relevant period, there appears to be any material contravention by the Institution of any of its duties under Parts XII, XV and XVIB of the Ordinance.

Chief Executive's Responsibilities

As the chief executive of the Institution you are responsible for establishing and maintaining adequate internal control systems to enable:

i. the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;

ii. the Institution to comply with its duties under Parts XII, XV and XVIB of the Ordinance.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1 [15] and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

Auditor's Responsibilities

Our responsibility is to prepare a report on the matters referred to in section 63(3A)(a) and (b) of the Ordinance based on the results of the procedures performed by us.[16]

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

[16] Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

We conducted our engagement for the examination of relevant internal control systems in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* ("PN 830 (Revised)") issued by the HKICPA. We have planned and performed our work to obtain reasonable assurance for giving conclusion 1 and obtain limited assurance for giving conclusion 2 below.

In respect of our examination of relevant internal control systems for conclusion 1 below, our work was based upon obtaining an understanding of the relevant control procedures in operation by enquiry of management and review of documents supplied to us. Our work included tests of control procedures and policies to establish whether relevant control objectives and internal control measures were designed by management for meeting the requirements specified in SPM IC-3.

In respect of conclusion 2 below, we have planned and performed such procedures as we considered necessary with reference to the procedures recommended in PN 830 (Revised). The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

Inherent Limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

Conclusion

Based on the foregoing:

1.* in our opinion, in all material respects, during the relevant period, the internal control systems examined by us, so far as these relate to matters referred to in section 63(3A)(a)(i) and (ii) of the Ordinance, were established and maintained in accordance with the requirements set out in SPM IC-3; and

2. during the relevant period, we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIB of the Ordinance.

Intended Users and Purpose

This report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
[*Auditor's Address*]
[*Date*]

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* *For the conclusion section (1), the above example would be adopted for situation where the auditor has no reservations about the institution's systems of internal control; in this situation, option (i) would be adopted [an unqualified opinion]. Example modified conclusions are set out in Appendix 8 to this Practice Note.*

Example 5 – Section 59(2) report

It should be noted that the scope and content of a report under section 59(2) would vary depending on the purpose and requirements of the HKMA in commissioning such a report. The example below focuses on a review of internal control systems and is only intended to provide an illustration of how such a review report could be structured and presented but other forms of presentation may be appropriate subject to discussion and agreement with the AI and the Monetary Authority. The precise details of the report should be suitably modified to suit individual circumstances.

INDEPENDENT AUDITOR'S ASSURANCE REPORT ON SECTION 59(2) OF THE BANKING ORDINANCE

To [Appropriate Addressee] of XYZ Bank

In accordance with our engagement letter dated [*date*] ("Engagement Letter"), a copy of which is attached as Appendix [ ] to this report, we have carried out an engagement under section 59(2) of the Banking Ordinance (the "Ordinance") in relation to matters specified in the Letter of Instruction issued by XYZ Bank (the "Institution") dated [*date*].

Scope

The scope of our engagement is set out in the Letter of Instruction which requires:

1. a review of the internal control systems of the Institution which were in existence during the period from [*date*] to [*date*] (the "review period") against the requirements set out in the following modules of Supervisory Policy Manual ("SPM"), guidelines and circulars issued by the Monetary Authority:

   [*list of all relevant modules of SPM, guidelines and circulars issued by the Monetary Authority*]

2. [*set out other specified areas of review as appropriate*]*

Directors' Responsibilities

As the directors of the Institution you are responsible for establishing and maintaining adequate internal control systems which comply with the requirements of the Ordinance, and SPM, guidelines and circulars issued by the Monetary Authority. In fulfilling that responsibility, estimates and judgment must be made to assess the expected benefits and related costs of management information and of control procedures. The objective is to provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that banking risks are properly monitored and evaluated and that transactions are executed in accordance with established authorization procedures and are recorded properly, to enable you to conduct the business in a prudent manner.

Our Independence and Quality Control

We have complied with the independence and other ethical requirements of the *Code of Ethics for Professional Accountants* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is founded on fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behavior.

The firm applies Hong Kong Standard on Quality Control 1 [17] and accordingly maintains a comprehensive system of quality control including documented policies and procedures regarding compliance with ethical requirements, professional standards and applicable legal and regulatory requirements.

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

Auditor's Responsibilities

Our responsibility is to perform an engagement in accordance with the Engagement Letter addressing the scope set out in the Letter of Instruction and report on:

a. whether we are aware of any matters which may indicate that the Institution has not established and maintained controls in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority; and

b. [*set out responsibilities for other specified areas of review as appropriate*]*.

based on the results of the procedures performed by us.[18]

We conducted our engagement in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* issued by the HKICPA for the purpose of reporting on whether relevant internal control systems of the Institution were established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority. We have planned and performed our work to obtain limited assurance for giving conclusion 1 below.

A limited assurance engagement undertaken in respect of our conclusion 1 below, in accordance with HKSAE 3000 (Revised) involves [level of detail about procedures to be determined by the auditor]. The procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than for, a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed.

In respect of [*other specified areas of review*], [our engagement was conducted in accordance with [*Hong Kong Standard on Assurance Engagements 3000 (Revised)*]* [*Hong Kong Standard on Related Services 4400 Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*]* and with reference to PN 830 (Revised) issued by the HKICPA.][19]

We have performed such procedures [*as we considered necessary for the purpose of reporting in accordance with the above requirements*]* [*as were agreed and set out in the Engagement Letter*]*.

Inherent Limitations

Accounting and internal control systems designed to address specific control objectives are subject to inherent limitations of any internal control structure, and accordingly, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

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18 Auditors may consider it appropriate to clarify to whom they are responsible here or elsewhere in the letter in accordance with their risk management policies and with reference to Professional Risk Management Bulletin No. 2 "Auditors' Duty of Care To Third Parties and The Audit Report".

19 This is for reference only and is not served to limit the appointed auditor's professional judgement and initiative, or limits the application of relevant standards. The work of each engagement is to be designed to meet the requirements of the Monetary Authority and particular situation.

Conclusion

Based on the foregoing, [with the exception of the matters set out in the findings and recommendations arising from our review of the internal control systems set out in Appendix [ ] to this report][20]:

1. having regard to the nature and scale of the business of the Institution, during the review period, nothing has come to our attention that causes us to believe that the Institution's internal control systems were not established and maintained in accordance with the requirements set out in the above modules of SPM, guidelines and circulars issued by the Monetary Authority; and

2. [*conclude on other specified areas of review as appropriate*].

Intended Users and Purpose

This report is for the information of the Institution and its Board of Directors in dealing with the matters set out in the Letter of Instruction dated *[date]* and for submission to the Monetary Authority. Except for the foregoing, this report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
[*Auditor's Address*]
[*Date*]

** Delete where not appropriate*

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[20] In the circumstances where the auditor expresses a qualified conclusion or a disclaimer of conclusion or adverse conclusion, the auditor's report is to be modified accordingly as required in paragraph 69(l)(v) of HKSAE 3000 (Revised), Further guidance is set out in paragraphs 74 to 77, A182, A188 to A191 of HKSAE 3000 (Revised).

Example 6 – Report of factual findings in relation to voluntary revocation of authorization

REPORT OF FACTUAL FINDINGS IN RELATION TO XYZ'S APPLICATION FOR VOLUNTARY REVOCATION OF ITS AUTHORIZATION AS A [*DEPOSIT-TAKING COMPANY / RESTRICTED LICENCE BANK / BANK*]*

To [Appropriate Addressee] of XYZ Bank

In accordance with your Letter of Instruction dated [*date*], a copy of which is attached, we have performed the procedures below with respect to XYZ (the "Institution"). Our engagement was conducted 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 for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution's application for voluntary revocation of authorization as a [*deposit-taking company / restricted licence bank / bank*]*. The procedures are summarized as follows:

1. We inspected the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [*date*].

2. We obtained from the management the balance sheet of the Institution as at [*date*] and agreed to the books and records of the Institution as at [*date*].

3. We obtained from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [*date*] and compared it to the books and records.

4. For the contingent liabilities and outstanding commitments, we also obtained and reviewed the minutes of the Board of Directors ("Board Minutes") for the period from [*date*] to [*date*].

5. We obtained a Representation Letter from the Board of Directors confirming the following:

   a. the accuracy and completeness of third party deposit liabilities of the Institution as at [*date*];

   b. the balance sheet as at *[date]* agreed with the books and records of the Institution;

   c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [*date*].

We report our findings as follows:

a. With respect to item 1, we found there were no third party customer deposit liabilities as attached as at [*date*], and this was consistent with the information in the Representation Letter.

b. With respect to item 2, we found the attached balance sheet as at [*date*] was in agreement with the books and records of the Institution as at [*date*], and was consistent with the information in the Representation Letter.

c. With respect to item 3, we found the attached summary of contingent liabilities and outstanding commitments as at [*date*] was in agreement with the Institution's books and records, and was consistent with the information in the Representation Letter.

d. With respect to item 4, we were not aware of any inconsistency of the information in the Board Minutes.

Because the above procedures do not constitute an assurance engagement 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, we do not express any assurance on the Institution's balance sheet, third party deposit liabilities, contingent liabilities and commitments as at [*date*].

Had we performed additional procedures or had we performed an assurance engagement 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. It relates only to the items specified above and does not extend to any financial statements of the Institution, taken as a whole.

This report is intended for filing with the Monetary Authority. We have no objection that a copy of this report is given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, this report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

ABC & Co.
Certified Public Accountants (Practising) [or Certified Public Accountants]
[*Address*]
[*Date*]

** Delete where not appropriate*

APPENDIX 2
Examples of management representation letters

The following specimen letters are for reference only and will need to be modified according to the requirements and circumstances of individual AIs.

Example 1 – Management representation letter for reporting under section 63(3)

[Client's letterhead]

[Audit Firm]
[Address]

[Date of Auditor's report]

Dear Sirs

This representation letter is provided in connection with your engagement pursuant to the requirements of section 63(3) of the Banking Ordinance to report on the following returns ("the Returns"):

i) the [*consolidated*]* Return of Capital Adequacy Ratio of the [*Bank / Company*] as at [*date*]; [*applicable to locally incorporated AIs only*]

ii) Parts I, II, and III, columns 1 - 5 of the [*consolidated*]* Return of Large Exposures of the [*Bank / Company / Branch*]* for the quarter ended [*date*];

iii) the [*consolidated*]* Return of Liquidity Position of the [*Bank / Company / Branch*]* for the month of [*month/year*]; and

iv) the [*consolidated*]* Certificate of Compliance of the [*Bank / Company / Branch*]* for the quarter ended [*date*].

We confirm that (, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

The Returns

1. We have fulfilled our responsibilities for establishing and maintaining adequate accounting and non-accounting records and systems of control to ensure that the Returns have been correctly compiled from the books and records of the [*Bank / Company / Branch*]*, and that the *[Bank / Company / Branch]** complies with the provisions of the Banking Ordinance at all times.

2. There have been no contraventions by the [*Bank / Company / Branch*]* of any of its duties under Part XII, XV, [*XVIA*]* [*applicable to locally incorporated AIs only*] or XVIB of the Banking Ordinance during the period from [*date*] to [*date*] or which were the subject of correspondence during this period.

3. We are not aware of any matter which adversely affects the financial position of the [*Bank / Company / Branch*]* to a material extent.

4. [*For registered institutions only*] We are not aware of any matter that constitutes on the part of the [*Bank / Company / Branch*]* a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.

5. We have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.

6. All the Returns have been prepared in accordance with the relevant completion instructions, Supervisory Policy Manual, guidelines and circulars issued by the Monetary Authority.

Information Provided

7. All the returns provided to you for the purpose of this engagement are the ones submitted to the Monetary Authority on the following dates (Note: Specify the dates of submission for respective returns which are within the scope of section 63(3) reporting).

8. All transactions undertaken by the [Bank / Company / Branch]* have been properly reflected and recorded in the accounting and non-accounting records.

9. All of the following information has been made available to you for the purposes of performing your procedures on the Returns:

   i) All accounting and non-accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments (including derivative transactions and credit arrangements) of the [*Bank / Company / Branch*]*;*

   ii) All procedures manuals for the preparation of the Returns and compliance with the Banking Ordinance;

   iii) Policies and procedures manuals for the key operating areas of the *[Bank / Company/ Branch]**;

   iv) All instructions, correspondence and minutes or notes of meetings with the Monetary Authority;

   v) Identities of all connected parties for the purpose of Part I of the Return of Large Exposures;

   vi) Other information which may be relevant to the preparation of the Returns; and

   vii) Unrestricted access to persons within the [Bank / Company / Branch]* from whom you determine it necessary to obtain audit evidence.

10. We have disclosed to you all communications between the [*Bank / Company / Branch*]* and the Monetary Authority and other regulatory authorities concerning non-compliance with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which could have a material effect on the information presented in the Returns.

11. We have communicated to you all deficiencies in internal control of which we are aware of that could have a material effect on the information presented in the Returns.

Yours faithfully

[*For and on behalf of…….*]

____________________________ ____________________________

Director*/Chief Executive* Chief Accountant

* *Delete where not appropriate*

Example 2 – Management representation letter for reporting under section 63(3A)

[Client's letterhead]

[Audit Firm]
[Address]

[Date of Auditor's report]

Dear Sirs

This representation letter is provided in connection with your engagement pursuant to the requirements of section 63(3A) of the Banking Ordinance for the examination of our internal control systems to enable:

i) the returns or information of the *[Bank / Company / Branch]** submitted to the Monetary Authority to be correctly compiled, in all material respects, from the books and records of the *[Bank / Company / Branch]**;

ii) the [*Bank / Company / Branch*]* to comply with its duties under Parts XII, XV, [*XVIA*]* [*applicable to locally incorporated AIs only*] and XVIB of the Banking Ordinance; and

iii) the [*Bank / Company / Branch*]* to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur [*applicable to locally incorporated AIs only*]

for the period/year ended [*date*].

We confirm that (, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

Internal Control Systems

1. We have fulfilled our responsibilities for establishing and maintaining adequate internal control systems.

2. There were no changes made subsequent to the reporting date which would significantly affect the systems of internal control, including any corrective action taken by management with regard to material weaknesses.

3. We are not aware of any violations or possible violations of the Companies Ordinance, the Banking Ordinance or any other regulations the effect of which should be considered for disclosure or as a basis for a provision.

4. There have been no contraventions by the [*Bank / Company / Branch*]* of any of its duties under Part XII, XV, [*XVIA*]* [*applicable to locally incorporated AIs only*] or XVIB of the Banking Ordinance during the period from [*date*] to [*date*].

5. The [*Bank / Company*]* has maintained at all times during the review period adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur [*applicable to locally incorporated AIs only*].

6. We are not aware of any matter which adversely affects the financial position of the [*Bank / Company / Branch*]* to a material extent.

7. [*For registered institutions only*] We are not aware of any matter that constitutes on the part of the [*Bank / Company / Branch*]* a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance.

8. We have read the draft auditor's report and have agreed with the facts and statements set out in the draft report in respect of your engagement.

Information Provided

9. All of the following information has been made available to you for the purposes of performing your procedures on the relevant internal control systems:

   i) Written procedures regarding the preparation of banking returns and compliance with the Banking Ordinance;

   ii) All instructions and correspondence with the Monetary Authority;

   iii) All accounting and non-accounting records;

   iv) Any other necessary information; and

   v) Unrestricted access to persons within the [*Bank / Company / Branch*]* from whom you determine it necessary to obtain audit evidence.

10. We have disclosed to you all material weaknesses in the internal control systems of which we are aware and also those areas for which management believes the cost of corrective action may exceed the benefits.

11. We have disclosed to you any irregularities involving management or employees who have significant roles in the systems of internal control.

12. We have disclosed to you all communications between the [*Bank / Company / Branch*]* and the Monetary Authority and other regulatory authorities concerning non-compliance with laws and regulations or deficiencies in internal control systems and procedures and financial reporting practices which could have a material effect on the banking returns.

13. There are no other records or related information, including significant matters addressed and resolutions adopted at any [directors'/management] meetings for which minutes have yet to be finalised, which have not either been brought to your attention or provided to you.

Yours faithfully`

[*For and on behalf of …….*]

______________________	______________________
Director*/Chief Executive*	Chief Accountant

* *Delete where not applicable*

Example 3 – Management representation letter for report of factual findings in relation to voluntary revocation of authorization

[Client's letterhead]

[Audit Firm]
[Address]

[Date of report]

Dear Sirs

This representation letter is provided in connection with your performance of the agreed-upon procedures in respect of the voluntary revocation of the authorization of the [*Bank / Company / Branch*]*.

We confirm that (, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves):

Financial Statements

1. We have fulfilled our responsibilities for establishing and maintaining adequate accounting records and systems of control to ensure that the financial statements of the [*Bank / Company / Branch*]* for the period from [*date*] to [*date*] have been properly prepared from the books and records of the [*Bank / Company / Branch*]*.

2. We confirm the following:

   (a) As at [*date*], the third party deposit liabilities of the [*Bank / Company / Branch*]* are accurate and complete;

   (b) As at [*date*], the [*Bank / Company / Branch*]* 's balance sheet agrees with the books and records made available to you. The *[Bank / Company / Branch]** has maintained adequate provision for its liabilities and commitments as at [*date*]; and

   (c) As at [*date*], there are no other outstanding commitments or contingent liabilities which have not been wound down or properly honoured or transferred by mutually satisfactory arrangements except for those stated in the summary of contingent liabilities and outstanding commitments as at [*date*] and disclosed in the attachment to your report. The summary of contingent liabilities and outstanding commitments are accurate and complete.

Information Provided

3. All transactions undertaken by the [*Bank / Company / Branch*]* have been properly reflected and recorded in the accounting records.

4. All of the following information has been made available to you for the purposes of performing your procedures:

   (a) All accounting records and supporting documents, information and explanations necessary for an understanding of the nature of transactions entered into, the assets owned, the liabilities (contingent or otherwise) and commitments of the [*Bank / Company / Branch*]*;

   (b) All relevant instructions, correspondence and minutes or notes of meetings with the Monetary Authority and our solicitors; and

   (c) Other information which may be relevant to your agreed-upon procedures.

Yours faithfully

[*For and on behalf of…….*]

____

Director*/Chief Executive*

* *Delete where not applicable*

APPENDIX 3
Examples of engagement letters

The following example letters highlight only the aspects relating to the scope and responsibilities of the auditor for the purpose of reporting under the Banking Ordinance. These examples are for reference only and require the inclusion of other relevant terms of the engagement which will vary according to the requirements and circumstances of the individual auditor and client. The auditor may consider it appropriate to include a limitation of liability clause in the engagement letter in accordance with the auditor's risk management policies.

Example 1 – Engagement letter for reporting under section 63(3) and (3A) for locally incorporated AIs

The Board of Directors
XYZ Bank
[*address*]

[*Date*]

Dear Sirs

Objective of services

1.1 You have requested that we report on certain returns and systems of control of XYZ Bank (the "Institution") under section 63(3) and (3A) of the Banking Ordinance (the "Ordinance"). The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [*date*]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our expressing a conclusion on the returns and systems of control.

Responsibilities of the directors

2.1 Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.

2.2 Reporting under Section 63(3) of the Ordinance

It is the directors' responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

2.3 Reporting under section 63(3A) of the Ordinance

It is the directors' responsibility to establish and maintain adequate internal control systems to enable:

i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;

ii) the Institution to comply with its duties under Parts XII, XV, XVIA and XVIB of the Ordinance;

iii) the Institution to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

2.4 The directors are responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 2.3 above and paragraphs 3.2 and 4.3 below.

Responsibilities of the auditor

3.1 Reporting under Section 63(3) of the Ordinance

Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

3.2 Reporting under section 63(3A) of the Ordinance

i) Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the Monetary Authority, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.

ii) In addition, our duty as auditor is to report whether or not, during the period:

a) we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVIA or XVIB of the Ordinance;

b) we are aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.

The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

Scope of work

4.1 The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [*date*].

4.2 Reporting under Section 63(3) of the Ordinance

i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The procedures that we will perform to enable us to form our opinion will also be carried out pursuant to the requirements of section 63(3) of the Ordinance, having regard to Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance" ("SPM IC-3") issued by the Monetary Authority. These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.

ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution's books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.

iii) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority.

4.3 Reporting under section 63(3A) of the Ordinance

i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) and with reference to Practice Note 830 (Revised) issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority.

ii) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.

4.4 As part of our procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the engagements on matters having a material effect.

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution rests with you, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services).

[*Set out other terms of the engagements as appropriate*]

Agreement of terms

5.1 Once it has been agreed, this letter will remain effective, from one appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our report under section 63(3) and 63(3A) of the Ordinance including our respective responsibilities.

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

____

Director, for and on behalf of the Board of XYZ Bank

Example 2 – Engagement letter for reporting under section 63(3) and (3A) for local branch(es) of overseas incorporated AIs

The Chief Executive
XYZ Bank – Hong Kong Branch
[*Branch address*]

[*Date*]

Dear Sirs

Objective of services

1.1 You have requested that we report on certain returns and systems of control of XYZ Bank's Hong Kong Branch (the "Institution") under section 63(3) and (3A) of the Banking Ordinance (the "Ordinance"). The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [*date*]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our expressing a conclusion on the returns and systems of control.

Responsibilities of management

2.1 Section 63(1) and (2) of the Ordinance require the Institution to prepare and submit regular returns to the Monetary Authority and to provide the Monetary Authority with any further information necessary for the exercise of its functions under the Ordinance.

2.2 Reporting under Section 63(3) of the Ordinance

It is management's responsibility to ensure the correct compilation of banking returns and other information, from the books and records of the Institution, for submission to the Monetary Authority.

2.3 Reporting under section 63(3A) of the Ordinance

It is management's responsibility to establish and maintain adequate internal control systems to enable:

i) the Institution's returns or information submitted to the Monetary Authority to be correctly compiled from the books and records of the Institution;

ii) the Institution to comply with its duties under Parts XII, XV and XVIB of the Ordinance.

2.4 The Institution's management is responsible for making available to us, all records and documents relating to the preparation of returns or other information, all records relating to the establishment and maintenance of internal control systems, copies of all correspondence, minutes or notes of meetings and discussions held between the Institution and the Monetary Authority relevant to our examination of the returns or other information, and any other information relevant to the matters referred to in paragraph 2.3 above and paragraphs 3.2 and 4.3 below.

Responsibilities of the auditor

3.1 Reporting under section 63(3) of the Ordinance

Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, in our opinion, certain returns and/or other information, as specified by the Monetary Authority, submitted by the Institution to the Monetary Authority, have been correctly compiled, in all material respects, from the books and records of the Institution and if not so correctly compiled, the nature and extent of the incorrectness. The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

3.2 Reporting under section 63(3A) of the Ordinance

i) Our duty as auditor is to submit a report to you for onward submission to the Monetary Authority stating whether or not, during the period on which we have been requested to report as specified by the HKMA, the Institution had in place systems of control, over the areas noted above, which were adequate, as much as is practicable, and that, if in our opinion those systems were not adequate, the nature and extent of any inadequacies.

ii) In addition, our duty as auditor is to report whether or not, during the period, we are aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIB of the Ordinance.

The report is solely prepared for you for onward submission to the Monetary Authority pursuant to Section 63(3A) of the Banking Ordinance and is not intended to be, and should not be, used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party in this respect.

Scope of work

4.1 The scope and period to be covered in these engagements are set out in the Letters of Instruction issued by the Institution dated [*date*].

4.2 Reporting under Section 63(3) of the Ordinance

i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised), *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* and with reference to Practice Note 830 (Revised), *Reports by the Auditor Under the Banking Ordinance* issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The procedures that we will perform to enable us to form our opinion will also be carried out pursuant to the requirements of section 63(3) of the Ordinance, having regard to Supervisory Policy Manual IC-3 "Reporting Requirements Relating to Authorized Institutions' External Auditors under the Banking Ordinance" ("SPM IC-3") issued by the Monetary Authority. These procedures do not comprise an audit, and accordingly, we will not be expressing an opinion on the truth and fairness of the figures and information included in the returns and/or other information on which we are required to report.

ii) Our procedures will be limited to agreeing relevant amounts in the banking returns to the Institution's books and records and checking whether the compilation procedures were performed in accordance with the completion instructions issued by the Monetary Authority for the relevant banking returns.

iii) Our report will be submitted to you within two months from the date of the notification letter issued by the Monetary Authority and you should forward the report to the Monetary Authority.

4.3 Reporting under section 63(3A) of the Ordinance

i) Our work will be carried out in accordance with Hong Kong Standard on Assurance Engagements 3000 (Revised) and with reference to Practice Note 830 (Revised) issued by the HKICPA. The procedures that we will perform to enable us to form our conclusion will also be carried out pursuant to the requirements of section 63(3A) of the Ordinance, having regard to SPM IC-3 issued by the Monetary Authority.

ii) Our report will be submitted to you within three months from the end of the period under review and you should forward the report to the Monetary Authority within a further month.

4.4 As part of our procedures, we will request you to provide written confirmation concerning representations which we have received from you during the course of the engagements on matters having a material effect.

4.5 The primary responsibility for keeping the Monetary Authority informed about the affairs of the Institution and XYZ Bank rests with you, and we shall advise you if, during the course of our work, we become aware of any matters that we consider you should report to the Monetary Authority. However you should appreciate that our work should not be relied upon to disclose all irregularities that may exist.

4.6 We shall not be treated as having notice, for the purposes of our responsibilities under section 63(3) and (3A) of the Ordinance, of information provided to members of our firm other than those engaged in the assignment (for example information provided in connection with accounting, taxation and other services, or information provided to the head office of XYZ Bank and/or its other branches).

[*Set out other terms of the engagements as appropriate*]

Agreement of terms

5.1 Once it has been agreed, this letter will remain effective, from one appointment to another, until it is replaced. Please sign and return the enclosed copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our report under section 63(3) and 63(3A) of the Ordinance including our respective responsibilities.

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

____

Chief Executive of XYZ Bank – Hong Kong Branch

Example 3 – Engagement letter for report of factual findings in relation to voluntary revocation of authorization

The Board of Directors
XYZ
[*address*]

[*Date*]

Dear Sirs

Objective of services

1.1 You have requested that we prepare a report in relation to an application for voluntary revocation of authorization as a [deposit-taking company/restricted licence bank/bank]* by XYZ (the "Institution"). The scope and period to be covered in this engagement are set out in your Letter of Instruction dated [*date*]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our work will be conducted with the objective of our reporting the factual findings.

Scope of work

2.1 Our engagement will be conducted 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") and we will indicate so in our report.

2.2 We have agreed to perform the following procedures and report to you the factual findings resulting from our work:

i) Inspect the general ledger and customer deposit records of the Institution to ascertain whether there were any third party deposit liabilities recorded as at [*date*].

ii) Obtain from the management the balance sheet of the Institution as at [*date*] and agree to the books and records of the Institution as at [*date*].

iii) Obtain from the management a summary of contingent liabilities and outstanding commitments of the Institution as at [*date*] and compare it to the books and records.

iv) For the contingent liabilities and outstanding commitments, obtain and review the minutes of the Board of Directors for the period from [*date*] to [*date*].

v) With respect to (i) – (iii) above, we will also obtain a Representation Letter from the Board of Directors confirming the following:

a. the accuracy and completeness of third party deposit liabilities of the Institution as at [*date*];

b. the balance sheet as at *[date]* agreed with the books and records of the Institution;

c. the accuracy and completeness of contingent liabilities and outstanding commitments of the Institution as at [*date*].

2.3 The procedures are performed solely for the purpose of assisting you in satisfying the requirements of the Monetary Authority in relation to the Institution's application for voluntary revocation of the authorization as a [deposit-taking company/restricted licence bank/bank]*. Our report is intended for filing with the Monetary Authority. We have no objection that a copy of our report will be given by the Monetary Authority to the Financial Secretary of the HKSAR Government for the purpose of section 22(1) of the Banking Ordinance. Except for the foregoing, our report should not be distributed to any other party or used by anyone else or for any other purpose and we expressly disclaim any liability or duty to any other party or for any other use in this respect.

2.4 The procedures that we will perform will not constitute an assurance engagement 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 and, consequently, we will not express any assurance on the Institution's balance sheet, third party deposit liabilities, contingent liabilities and commitments.

[*Set out other terms of the engagement as appropriate*]

Agreement of terms

3.1 We shall be grateful if you could confirm in writing your agreement to the terms of this letter by signing and returning the attached copy, or let us know if they are not in accordance with your understanding of our terms of appointment.

Yours faithfully

ABC & Co.

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

We agree to the terms of this letter.

____

Director, for and on behalf of the Board of XYZ

**Delete where not appropriate*

APPENDIX 4

Guidance on ad hoc reports under section 61

The following guidance been prepared to assist the auditor in understanding the circumstances in which the auditor would consider taking the initiative in bringing important matters to the attention of the HKMA with the protection of section 61 of the Banking Ordinance. Section 61 of the Banking Ordinance does not lay down any rules nor specify the circumstances in which the auditor is to communicate any matter to the HKMA. It provides a statutory mechanism whereby the auditor may make matters known to the HKMA without breaching the auditor's duty of confidentiality.

All section references in this Appendix are to the Banking Ordinance.

The auditor

1. Section 61 provides that no duty to which an auditor of an AI shall be subject will be contravened "by reason of his communicating in good faith to the Monetary Authority, whether or not in response to a request made by the Monetary Authority, any information or opinion on a matter to which he becomes aware in his capacity as auditor and which is relevant to any function of the Monetary Authority under this Ordinance". It is this section which makes it clear that the auditor is able to communicate with the HKMA by way of a formal report, at a meeting or by any other means on any matters relating to the AI's affairs arising out of the appointment and which are relevant to any function of the HKMA under the Ordinance. These matters include those which are relevant to the reports made by the auditor, to any discussions with the HKMA and to those exceptional circumstances which are referred to in paragraphs 13 and 14 of this Appendix. The HKMA believes that the auditor may communicate a matter to the HKMA with the protection of section 61 regardless of the source of that information, provided the auditor becomes aware of the matter in the capacity as the auditor of that client AI.

2. Confidentiality is generally either an implied or explicit term of the auditor's contracts with the clients, but in section 61 circumstances it does not prevail since the auditor is entitled to communicate information or opinions relating to the business or affairs of the AI without contravening the duty of confidence owed to the AI.

3. References in the following paragraphs of this guidance to "reporting under section 61" refer to reporting with the protection of section 61.

4. It is important to stress that the HKMA expects that the management of the AI will continue to be its primary source of information and that the normal reporting procedures, including the reports on statutory returns, the prudential meetings and any tripartite meetings will normally provide the HKMA with most of the information it needs to carry out its responsibilities under the Ordinance.

5. The auditor cannot, however, be expected to be aware of all circumstances which, had the auditor known of them, would have led the auditor to exercise the right to report under section 61. That section does not require the auditor to change the scope of the audit work, nor the frequency or timing of the audit visits. The auditor does not have an obligation to seek out grounds for making a report under section 61; the section does not place an obligation on the auditor to conduct the work in such a way that there is reasonable certainty that the auditor will discover an occurrence of the kind described in paragraph 10 of this Appendix. It is only when the auditor becomes aware in the ordinary course of the audit work of such an occurrence that the auditor would make detailed enquiries with section 61 specifically in mind.

6. The HKMA recognizes that it would not be appropriate for the auditor to report to it information which the auditor has obtained through the professional relationship with another client which is not the AI, even though the information obtained or the matters identified may relate to the AI.

7. The auditor would realize that there are circumstances in which section 61 will not provide protection, for example, where the auditor could be held to have acted maliciously or in bad faith. The Ordinance does not, therefore, provide complete immunity from all types of legal action by all parties affected, or subsequently affected, by the auditor's action in reporting to the HKMA. The auditor would consider taking legal or other professional advice before making the decision whether or in what manner to report and in order, for example, to ensure that the form and content of the report are such as to secure the protection of section 61 and that it only includes relevant material. However, the auditor would recognize that speed of reporting may well be important in order to protect the interests of depositors. There is no protection given by the Ordinance if the auditor fails to report to the HKMA.

The HKMA

8. Information which is confidential and has been obtained by the HKMA under, or for the purposes of, the Ordinance can only be disclosed in given circumstances. However, under section 120(5)(g), the HKMA is not precluded from disclosing information "to an auditor of an authorized institution or former authorized institution or to a former auditor for the purpose of enabling or assisting the Monetary Authority to discharge his functions under this Ordinance". It should be noted that disclosure by the HKMA of confidential information to the auditor is to the auditor only; the auditor is not free to pass that information to others, such as the client AI without the HKMA's consent.

9. The HKMA has confirmed that it will take the initiative, usually by calling a tripartite meeting, in bringing a matter to the attention of an AI and its auditor:

   a. when it believes that it is of such importance that the auditor's knowledge of it could significantly affect the form of the audit or other report or the way in which the auditor carries out the reporting responsibilities; and

   b. when the disclosure is for the purpose of enabling or assisting the HKMA to discharge its functions under the Ordinance or will otherwise be in the interests of depositors.

   The HKMA will indicate whether management of the AI has been informed of the matter and if so, who has been advised. If the auditor is not informed by the HKMA of any such matter, the auditor is entitled to assume that the HKMA has no such disclosure to make. Accordingly, there is no need for the auditor to request the HKMA to confirm this.

Taking the initiative

10. The HKICPA has developed a criterion for use by the auditor in deciding whether to take the initiative in making an ad hoc report in addition to the regular reporting responsibilities. The criterion is that the auditor would take the initiative when the auditor considers it expedient to do so in order to protect the interests of depositors because there has been a material loss or there exists a significant risk of material loss. This criterion can be more fully explained as follows:

    a. there must be an adverse occurrence, or a change in the auditor's perception of an existing situation, which may include an adverse change in the circumstances of the AI; and

    b. the position described in a. above has given rise to a material loss or indicates that a reasonable probability exists that a material loss may arise; and

    c. the position is such that the interests of depositors might be better safeguarded if the HKMA was aware of it.

11. As stated in paragraph 5 of this Appendix, the auditor is not required to seek out grounds for making a report. It is only where the auditor becomes aware during the ordinary course of the work that the criterion might be satisfied that the auditor would take the matter further.

Reporting via the AI

12. It is important for the auditor to act in a manner that will preserve the professional relationship with the client. Normally, therefore, the auditor would ask the AI to draw matters about which the auditor is concerned to the attention of the HKMA. Examples of circumstances encountered in which the criterion set out in paragraph 10 of this Appendix may be met and the matter reported via the AI are:

    a. when there appears to the auditor to be a material contravention of one or more of the requirements of the Ordinance;

    b. where it has come to the attention of the auditor that there is an extreme situation, such as evidence of imminent financial collapse, where it is obvious that the HKMA must be informed;

    c. where the auditor has evidence of an occurrence which has led or is likely to lead to a material diminution of the AI's net assets;

    d. when the auditor forms the opinion that there has been a significant failure of, or that there is a significant weakness in, the accounting and other records or the internal control systems;

    e. when the auditor forms the opinion that management has reported financial information to the HKMA which is misleading in a material particular (or become aware that management has failed or does not intend to report something and the failure to report is, or would be, materially misleading).

Reporting direct to the HKMA

13. In exceptional circumstances, where it is in the interests of protecting depositors that the management of the AI should not be informed in advance, the auditor would report direct to the HKMA after first considering the appropriateness of taking independent legal advice. Examples of these circumstances are:

    a. where there has been an occurrence which causes the auditor no longer to have confidence in the integrity of the directors or senior management, e.g. where the auditor believes that a fraud or other misappropriation has been committed by the directors or senior management of the AI, or they have evidence of the intention of directors or senior management to commit such fraud or misappropriation;

    b. where there has been an occurrence which causes the auditor no longer to have confidence in the competence of the directors or senior management to conduct the business of the AI in a prudent manner so as to protect the interests of depositors, e.g. where the auditor has discovered that the directors or senior management are acting in an irresponsible or reckless manner with respect to the AI's affairs, or they have evidence of an intention so to act.

14. Additionally, as outlined in paragraph 16.b. of this Appendix, a direct report would be made where the AI will not itself inform the HKMA of a matter, having been advised to do so by the auditor or where it has not done so within the period of time specified, or where there is not adequate evidence that the AI has properly reported the matter in question.

Reporting procedures

15. In forming a view as to whether it is expedient to report a matter to the HKMA, the auditor would follow the procedures in making enquiries and obtaining and assessing relevant evidence which are a normal part of forming a professional judgment in relation to an audit or investigation.

16. Where the auditor becomes aware of a matter which in the professional judgment the auditor considers ought to be reported to the HKMA, the auditor would consider adopting the following procedures, bearing in mind that speed may be of the essence:

    a. The auditor would consider the facts and, unless inappropriate in the circumstances, discuss the matter with the management of the AI.

    b. In normal circumstances, the auditor would establish whether the matter has already been reported by the AI through the usual channels, and if so, obtain from the AI a copy of the HKMA's written acknowledgement sufficient to establish that the matter has been properly reported.

       If the matter has not already been reported by management, the auditor would write to the AI setting out the views and requesting the directors or management to inform the HKMA of the matter, within a specified period of time. The auditor would then obtain from the AI evidence of prompt acknowledgement from the HKMA sufficient to establish that the matter has been properly reported.

       In the absence of such evidence, it may be appropriate for the auditor to report the matter directly to the HKMA, and to inform the management of the AI of the contents of the report.

       If the directors or management have not informed the HKMA and continue to refuse to inform it within the specified period of time, the auditor would report directly to the HKMA.

    c. If the situation is sensitive, for example in the circumstances outlined in paragraphs 13.a. and b. of this Appendix, it may be inappropriate to discuss the matter with the normal levels of management. The auditor would, therefore, consider reporting to the appropriate senior level within the AI with a view to the HKMA being informed of the situation by a senior representative of the AI. The auditor would then obtain evidence from the AI of prompt acknowledgement by the HKMA sufficient to establish that the matter has been properly reported. In the absence of such evidence, it will then be appropriate for the auditor to report directly to the HKMA.

    In exceptional circumstances where the auditor feels that in the interests of speed and/or, because of the nature of the matter, it is not appropriate or practical to inform or discuss the matter with anyone connected with the AI, the auditor would make an appropriate written or other report direct to the HKMA after considering the appropriateness of taking independent legal advice.

17. The auditor would have to satisfy themselves that the decision will stand up to examination at a future date on the basis of the following considerations:

    - what the auditor knew at the time;
    - what the auditor should have known in the course of the audit or investigatory work;
    - what the auditor should have concluded; and
    - what the auditor should have done.

18. Speed of reporting will often be important to the protection of the interests of depositors. A report would be made as soon as the auditor reasonably can after forming the view that it is expedient to do so in order to protect the interests of depositors. For the auditor this may well mean ensuring that an ad hoc report is made to the HKMA in advance of making the report after considering the appropriateness of taking independent legal advice.

19. The auditor would note that in the situations outlined in paragraphs 13 and 14 of this Appendix, making an ad hoc report alone may not discharge all the auditor's responsibilities. An example of this would be the auditor considering the implications of the ad hoc report for the auditor's opinion on the financial statements.

20. To ensure that the HKMA is informed promptly of matters which meet the criterion, a firm acting as the auditor or reporting accountant would ensure:

   a. that all staff responsible for banking and deposit-taking assignments are aware of the provisions of the appropriate legislation and the contents of this guidance, and are able to identify situations in which section 61 might operate; and

   b. that satisfactory procedures exist to ensure that any information, which may be the subject of an ad hoc report, obtained by staff in the course of the work, is passed on to the partner responsible without unnecessary delay.

APPENDIX 5

The Banking Ordinance – Important provisions for the auditor

This list is based on the Banking Ordinance which was effective as at 31 July 2018. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

Section

Powers of control over AIs

52 The Monetary Authority (MA) has powers to require an AI to take any action the MA deems necessary, to appoint a person to advise on the proper conduct of business, to assume control of the AI, to report matters to the Chief Executive in Council.

Power to examine and investigate AIs

55 The MA can examine books and records of an AI and group companies.

Audited financial statements

59 An AI and its auditor are required to comply with the Companies Ordinance with respect to the audit of the AI's financial statements; the MA has the power to appoint another auditor.

60 Requirement for an AI incorporated in Hong Kong to exhibit its audited financial statements in a conspicuous position in the principal place of business of the institution in Hong Kong and in each local branch not later than 4 months after the end of the financial year.

Reports on statutory returns used for prudential purposes

50(1)(c) The MA can require an auditor's report on returns or information on an overseas branch of an AI incorporated in Hong Kong.

63(3) The MA can require an auditor's report on returns or other information submitted to the MA under this section.

Reports on internal control systems

59(2) The MA can request ad hoc reports by the auditor on certain internal control systems.

63(3A) The MA can request recurring annual reports by the auditor on certain internal control systems and other matters.

Notification in respect of the auditor

59A(1) Requirement for an AI incorporated in Hong Kong to notify the MA with respect to proposed or actual changes of the auditor.

59A(2) Requirement for an auditor of an AI appointed under section 395, 396, 397 or 398 of the Companies Ordinance to notify the MA if he resigns, decides not to seek reappointment or decides to qualify the financial statements.

63A Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter which, in his opinion, adversely affects the financial position of an AI to a material extent.

63B Requirement for the auditor to submit a report in writing to the MA when he becomes aware of a matter that, in his opinion, is a matter that constitutes on the part of the institution a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section).

Communication by the auditor with the MA

61 Ability of the auditor to communicate to the MA certain information or opinion notwithstanding duties to clients (whether an AI or a former AI).

Investigations

117 Power of the Financial Secretary to appoint competent persons to investigate an AI and a former AI.

118 Duty of the auditor to provide information etc. to competent persons.

APPENDIX 6

Summary of relevant regulations and requirements issued by the SFC for the auditor to fulfil the duties under section 63B

This summary is based on the Securities and Futures Ordinance and its subsidiary legislation which were effective as at 31 July 2018. Every care has been taken in its preparation. Reference should however be made to the law for the precise requirements.

Section 157 of the Securities and Futures Ordinance (SFO)

Under section 157(3) of the SFO, "prescribed requirement" means such of the requirements under any of the rules made under section 148, 149, 151 or 152 of the SFO as are prescribed by rules made under section 397 of the SFO for the purposes of this definition.

Section 5 of the Securities and Futures (Accounts and Audit) Rules made under section 397(1) of the SFO

The following provisions are prescribed requirements for the purposes of the definition of "prescribed requirement" in section 157(3) of the SFO:

(a) sections 3 and 4 of the Securities and Futures (Keeping of Records) Rules;
(b) sections 4, 5, 6, 8(4), 10 and 11 of the Securities and Futures (Client Money) Rules; and
(c) sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules.

The Securities and Futures (Client Money) Rules are rules made under section 149 of the SFO. According to section 63B of the Banking Ordinance, the requirements under section 149 of the SFO or of rules made under that section are excluded.

Securities and Futures (Keeping of Records) Rules

This is a set of subsidiary legislation made under section 151 of the SFO which specifies the records that intermediaries and their associated entities are required to keep, the manner in which they are required to be kept and other matters relating to the keeping of the records.

Relevant sections

Section 3 General record keeping requirements for intermediaries

Section 4 Record keeping requirements for associated entities

Securities and Futures (Client Securities) Rules

This is a set of subsidiary legislation made under section 148 of the SFO which prescribes the manner in which intermediaries and their associated entities shall treat and deal with client securities and securities collateral received or held in Hong Kong.

Relevant sections

Section 4 Requirements in respect of a client's standing authority

Section 5 Requirement for deposit or registration of client securities and securities collateral

Section 10 Limitations on treatment of client securities and securities collateral

Section 12 Reporting of non-compliance with certain provisions of the Rules

APPENDIX 7

Checklist for the auditor

This checklist has been prepared for the guidance of the auditor who is required to report on compliance with Parts XII, XV, XVIA and XVIB of the Banking Ordinance based on the Banking Ordinance which was effective as at 31 July 2018. Every care has been taken in its preparation. Reference should however be made to the Banking Ordinance for the precise requirements.

All section references in this Appendix are to the Banking Ordinance.

Answer the following questions for the period to be covered by the report only:

Section Ref.

Part XII Disclosure of Information

1. Returns and information required by the HKMA

a. Returns and information

63(1) Did the AI submit the required monthly and quarterly returns and such other information to the HKMA within the required 14 days or such period as the HKMA may require?

b. Matters which adversely affect the financial position of the AI to a material extent

63A Are you aware of any matter that may adversely affect the financial position of the AI to a material extent? If so, a report in writing on the nature of the matter and the reason supporting this opinion are required to be submitted to the HKMA.

c. Failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance

63B Are you aware of any matter that constitutes on the part of the AI a failure to comply with any prescribed requirements within the meaning of section 157 of the Securities and Futures Ordinance (but excluding any requirements under section 149 of that Ordinance or of rules made under that section)? If so, a report in writing on the matter is required to be submitted to the HKMA as soon as reasonably practicable.

d. Shareholding

64(1)&(2) Has the AI informed the HKMA of the name, address, nature of business and other information required about companies:

i. in which the AI beneficially holds 20% or more of the issued shares ;

ii. where any director or manager of that company is also a director, chief executive or manager of the AI;

iii. where the name of that company has common features with the name of the AI;

iv. which, by whatever means, acts in concert with the AI to promote the AI's business; or

v. the controller of which is also the controller of the AI.

e. Changes to constitution

65 Are there changes to the constitution of the AI of which the HKMA has not yet been notified within the required 30 days?

f. Cessation of business

66 Has the AI ceased to carry on banking/deposit-taking business and if so, has it notified the HKMA in writing?

g. Inability to meet obligations

67(1) Is the AI likely to become unable to meet its obligations or is it about to suspend payment? If so, has it notified the HKMA?

2. Maintenance of adequate provision for depreciation and diminution in value of assets

63(3A) Has the AI at all times during the period under examination had in place systems of control which are adequate to enable it to maintain adequate provision:

a. for depreciation;

b. against the diminution, if any, in the value of its assets, including provision for bad and doubtful debts;

c. for liabilities which will or may fall to be discharged by it; and

d. for losses which will or may occur?

Part XV Limitation on Exposures and Interests of AIs

3. Advance against security of own shares

80 Has the AI complied with the requirement not to grant any advances, loans or credit facilities (including letters of credit) or give any financial guarantee or incur any other liability:

a. against the security of its own shares; and

b. against the security of the shares of

80(2) i. any holding company of the AI;

ii. any subsidiary of the AI; or

iii. any other subsidiary of any holding company of the AI,

except with the approval in writing of the HKMA?

4. Limitation on advances

81(1) a. Has the AI instituted an adequate and effective management control to ensure that its financial exposure to:

i. any one person;

ii. any two or more companies which have the same holding company;

iii. any two or more companies which have the same controller;

iv. any holding company and one or more of its subsidiaries;

v. any one person and one or more companies of which that person is a controller,

does not exceed 25% of its capital base?

Notes:

81(2) *[1] Financial exposure for this purpose means the aggregate of:*

[a] all advances, loans and credit facilities (including letters of credit) by the AI;

[b] the value of the AI's holdings of shares and debentures and other debt securities issued by that company, person or combination thereof;

[c] financial exposures (declared in a notice to be financial exposure) of the AI to that company, person or combination thereof; and

[d] the principal amount, multiplied by a factor specified by the HKMA and published in the gazette.

81(6) *[2] Financial exposure does not include:*

- *exposure to other AIs;*
- *exposure to an overseas incorporated bank which is not an AI where it is, in the opinion of the HKMA, adequately supervised by the relevant banking supervisory authority;*
- *exposure to the extent to which it is secured by a cash deposit, a guarantee, an undertaking which is similar to a guarantee, or securities issued, or guaranteed, by the central government or the central bank of any Tier 1 country within the meaning of Part 1 section 2 of the Banking Ordinance and such collateral or guarantee is accepted by the HKMA. The general criteria that the HKMA will apply in assessing whether such collateral or guarantee is acceptable are set out in the HKMA's Supervisory Policy Manual CR-L-2 "Exemption of Financial Exposures:§81(6)(b)(i)";*
- *exposure to the extent to which it is covered by a letter of comfort accepted by the HKMA. See CR-L-3 "Letters of Comfort: §81(6)(b)(ii)" for the criteria that the HKMA will apply in assessing whether such letters of comfort are acceptable;*
- *exposure acquired by the purchase of bills of exchange or documents of title to goods where the holder of such bills or documents is entitled to payment outside Hong Kong for goods exported from Hong Kong;*
- *advances, loans and credit facilities made against the bills or documents mentioned above;*
- *exposure to the Hong Kong Special Administrative Region Government or any other government acceptable to the HKMA;*
- *share capital or debt securities held as collateral for facilities granted or acquired by the AI during debt recovery. In the latter case, the AI is, however, required to dispose of such collateral at the earliest possible opportunity, and in any case within 18 months after the acquisition or within such further period as may be approved by the HKMA;*
- *an indemnity issued by the AI to a person to protect that person from any damages which may be incurred as a result of the person registering a transfer of shares (e.g. lost share certificates), provided that certain specified conditions are met;*

- *exposure acquired under an underwriting or sub-underwriting contract. If the exposure is an on balance sheet item, the exemption will only last for a period not exceeding seven working days or such further period as may be approved by the HKMA (see the HKMA's Supervisory Policy Manual CR-L-4 "Underwriting of Securities: §§81 and 87" for the HKMA's policy on extending the exemption period for the underwriting or sub-underwriting of securities). With effect from 13 July 2018, section 87 on limitation on shareholding by authorized institutions was repealed. The Banking (Exposure Limits) Rules ("BELR") on equity exposures have come into effect on 13 July 2018. Please refer to BELR for the details of requirements.*
- *exposure to a multilateral development bank as defined in Part 1 section 2 of the Banking Ordinance;*
- *exposure to the Housing Authority arising from guarantees given to AIs under the Home Ownership or Private Sector Participation Scheme;*
- *exposure to The Hong Kong Mortgage Corporation Limited (HKMC) arising from its obligations under the Mortgage Insurance Programme;*
- *exposure to the extent that it has been written off or specifically provided for in the books of the AI; and*
- *exposure to the HKMC or any company that issues mortgage-backed securities in connection with the HKMC's Guaranteed Mortgage-Backed Pass-Through Securitisation Programme, if the exposure to the HKMC or the company arises from the obligations placed upon it for the purposes of the Programme.*

b. Are you aware of any financial exposure of the AI during the period under review which was in contravention of this limitation?

81(6) c. In respect of transactions covered by a "letter of comfort", is the aggregate amount of the financial exposure within the limitation imposed by:

- the HKMA; or
- the terms of the letter of comfort?

Notes:

[1] This section does not apply to AIs incorporated outside Hong Kong.

79A [2] The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.

5. Compliance with guidelines on business practices

82(1) Has the AI complied with the requirement not to engage in those business practices specified in the guidelines, if any, published by the HKMA, after consultation with the Financial Secretary by notice in the Gazette?

Notes:

[1] The HKMA has the discretion to prohibit those business practices, which it considers will or may cause the soundness of the financial position of AIs to be dependent upon the soundness of the financial position of a single party.

82(2) [2] Such guidelines may apply to all AIs or to a class of AIs as specified in the notice.

[3] Such guidelines may specify what constitutes a single party and, without prejudice to the generality of that power, any class or description of persons or business may constitute such a single party.

6. Limitation on advances to directors etc.

83 a. Has the AI instituted an adequate and effective management control to ensure that it does not grant, or permit to be outstanding, any unsecured* advances, loans, credit facilities, financial guarantees or incur any other unsecured* liability to:

79(3) * Unsecured is defined as being granted without "such security as would, in the opinion of the HKMA be acceptable to a prudent banker". In this connection it is considered that an unsupported personal guarantee does not constitute security.

83(4) i. any director of the AI;

ii. any relative of such director;

iii. any employees responsible, either individually or as a member of a committee, for approving loan applications;

iv. any relative of any such employee;

v. any controller of the AI;

vi. any relative of an individual who is a controller of the AI;

vii. any firm, partnership or non-listed company in which the AI or any of its controllers or its directors (or relative of its controllers or directors) is interested as director, partner, manager or agent; and

viii. any individual, firm, partnership or non-listed company of which any of the AI's controllers or directors (or relative of its controllers or directors) is a guarantor,

83(1) to an aggregate amount in excess of

aa. 10% of the capital base of the AI; or

83(2) bb. 5% of the capital base of the AI in respect of one or more persons included in i. to vi. above; or

cc. $1,000,000 in respect of any one person included in i. to vi. above.

b. Are you aware of any loans or advances etc. granted or outstanding during the period under examination which were in contravention of any of these limitations?

Notes:

83(5) [1] The above shall apply to a facility granted jointly with another party as they apply to a facility granted severally.

83(1) [2] The above section does not apply to AIs incorporated outside Hong Kong.

79A [3] The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis or both bases.

7. Limitation on advances to employees

85 Has the AI complied with the requirement not to grant, or permit to be outstanding, unsecured* advances, loans, credit facilities to, and not to give unsecured* financial guarantees or incur any other unsecured* liability in respect of, any one of its employees to an aggregate in excess of one year's salary for any such employee?

79(3) * Unsecured is defined as being granted without "such security as would, in the opinion of the HKMA, be acceptable to a prudent banker". In this connection it is considered that an unsupported personal guarantee does not constitute security.

8. Moneys placed with foreign banks

86 Is there any notice from the HKMA prohibiting the AI from granting any advances, loans, deposits or credit facilities to or directing the AI to demand repayment from any foreign banks?

Note:

86(4) "Foreign bank" means:

[1] any bank incorporated outside Hong Kong which is not licensed under the Banking Ordinance;

[2] any undertaking of an AI which is situated outside Hong Kong.

9. Limitation on equity exposures

BELR 10,11 Has the AI complied with the requirement that its equity exposure ratio does not exceed 25 % at all times, subject to any variation served on the AI by the HKMA?

BELR 12 In calculating the equity exposure ratio, has the AI correctly calculated its aggregate equity exposures, taking into account relevant rules relating to aggregation of exposures arising from its banking and trading book, offsetting and treatment of net short position in an equity exposure?

BELR 13 In calculating the equity exposure ratio, has the AI correctly excluded the following interests which are not taken into account for calculating the institution's equity exposure ratio:

a. holding of any share capital that is held as security for facilities granted by the AI;

b. holding of any share capital that is acquired in the course of satisfaction of debts due to the AI. In any event, such acquisitions must be disposed at the earliest suitable opportunity, or within 18 months unless the HKMA has agreed to an extension of time;

c. holding of any share capital by virtue of specified underwriting or subunderwriting contracts, provided that the period of 7 working days after the acquisition of the share capital has not expired, unless the HKMA has agreed to an extension of time and any additional conditions are complied with;

d. any commitment to acquire the share capital of any company or companies under an underwriting or subunderwriting contract that falls within an equity exposure under rule 8(2)(i);

e. in respect of shareholdings, approved in writing by the HKMA, in another AI or in a company carrying out nominee, executor or trustee functions or other functions related to banking/deposit-taking business, insurance business, investments or other financial services;

f. in respect of any holding, approved by the HKMA, of share capital which is deducted in determining the capital base of the AI under Part 3 of the Capital Rules;

g. any equity exposure up to the amount incurred by the AI specifically to offset the above items;

h. any equity exposure arising from the holding of assets, or incurring of liabilities, in relation to a defined benefit pension fund or plan; or

i. any equity exposure that is specified in a consent given by HKMA and in relation to the consent any conditions imposed are complied with?

With effect from 13 July 2018, section 87 on limitation on shareholding by authorized institutions was repealed. The BELR on equity exposures have come into effect 13 July 2018. Please refer to BELR for the details of requirements.

Notes:

BELR 9 *[1] Part 2 of the BELR, which includes the above rules, do not apply to AIs incorporated outside Hong Kong.*

BELR 5 *[2] The HKMA may require the rules to apply to AIs on a consolidated basis, unconsolidated basis or both bases.*

[3] Please note that if the scope of sections 63(3) and/or 63(3A) reporting covers the periods up to 12 July 2018, sections 87 and 90 of the Banking Ordinance are still applicable for those periods up to 12 July 2018.

87A Has the AI complied with the requirement not to acquire all or part of the share capital of a company to a value of 5% or more of the capital base of the AI at the time of the acquisition except with the approval of the HKMA.

Notes:

79A [1] The HKMA may require section 87A to apply to AIs on a consolidated basis, unconsolidated basis or both bases.

10. Limitation on holding of interest in land

88(1) Has the AI complied with the requirement not to purchase or hold any interest in land situated in or outside Hong Kong of an aggregate value which exceeds 25% of its capital bases excluding:

88(2)/(3) a. land necessary for occupation for its business purposes or for staff housing; and

88(5) b. the value of land mortgaged to the AI by way of security for debts due to the AI, or the value of any interest acquired pursuant to entry into possession of land so mortgaged, provided that such mortgaged land must be disposed of within 18 months unless the HKMA has agreed to an extension?

Notes:

88(1) [1] This section does not apply to AIs incorporated outside Hong Kong.

79A [2] The HKMA may require this section to apply to AIs on a consolidated basis, unconsolidated basis, or both bases.

Part XVIA Capital Requirements

11. Capital requirements

97C(5) Has the AI complied with the rules made under section 97C(1)?

97D(1)&(2) Has the AI notify the HKMA in compliance with the prescribed notification requirement?

Notes:

97C(1)&(2) [1] The HKMA may, after consultation with the Financial Secretary and (a) the Banking Advisory Committee; (b) the Deposit-taking Companies Advisory Committee; (c) the Hong Kong Association of Banks and (d) the DTC Association, make rules prescribing capital requirements for AIs, taking into account the risks associated with the AIs and for connected purposes.

97C(3) [2] The rules made under section 97C(1), may

- *(a) make different provisions for different classes of AIs, taking into account the risks associated;*
- *(b) give effect to banking supervisory standards relating to capital issued by the Basel Committee, whether in whole or in part and subject to any modifications the HKMA thinks fit;*
- *(c) apply, adopt or incorporate by reference, with or without modifications, any document relating to capital issued by the Basel Committee, whether in whole or in part and whether in force at the time of issue or as in force from time to time;*
- *(d) if the AI has one or more than one subsidiary, specify, or empower the HKMA to specify, that any capital requirement rule applicable to the AI is to apply to the AI on an unconsolidated basis, to the AI and one or more of such subsidiaries on a consolidated basis, or both;*
- *(e) provide that a matter prescribed in the rules must immediately notify the HKMA or must provide particulars to the HKMA on request;*
- *(f) provide for the HKMA, on application made by an AI aggrieved by a decision of the HKMA, to review the decision;*
- *(g) prescribe a capital requirement in the form of a range with upper and lower limits, and the circumstances under which the HKMA may determine a specific capital requirement within that range to apply to an AI; and*
- *(h) contain incidental, supplementary, consequential, transitional or savings provisions that may be necessary or expedient in consequence of the rules*

97D(1)&(2) [3] "Prescribed notification requirement" means a requirement prescribed in the rules made under section 97C(1) to the effect that an authorized institution must in respect of a matter prescribed in the rules immediately notify the HKMA. If, in compliance with a prescribed notification requirement, an AI notifies the HKMA of a failure to comply with a capital requirement rule relating to a minimum level of capital to be maintained by the AI, the HKMA must immediately notify the Financial Secretary and provide the Financial Secretary with any particulars of the failure that the Financial Secretary requires.

97E(1)&(2) [4] If the AI contravenes section 97C(5) then the HKMA and the AI will determine a remedial action plan which the AI will be required to follow.

97F(1) [5] The HKMA may vary any capital requirement rule applicable to a particular AI.

97B [6] The requirement does not apply to AIs incorporated outside Hong Kong.

Part XVIB Liquidity Requirements

12. Liquidity requirements

97H(6) Has the AI complied with the rules (i.e. the Banking (Liquidity) Rules) made under section 97H(1) and the Code of Practice made under section 97M(1) (where applicable) on all positions that are applicable to the AI?

97I(1)&(2) Has the AI notified the HKMA of a relevant liquidity event (as defined in Rule 14 of the Banking (Liquidity) Rules) in compliance with the prescribed notification requirement?

Notes:

97H(1)&(2) [1] The HKMA may, after consultation with the Financial Secretary and (a) the Banking Advisory Committee; (b) the Deposit-taking Companies Advisory Committee; (c) the Hong Kong Association of Banks and (d) the DTC Association, make rules prescribing liquidity requirements for AIs, taking into account the liquidity risks associated with the AIs and for connected purposes.

97H(3) [2] The rules made under section 97H(1), may

- *(a) make different provisions for different classes of AIs, taking into account the liquidity risks associated;*
- *(b) give effect to banking supervisory standards relating to liquidity issued by the Basel Committee, whether in whole or in part and subject to any modifications the HKMA thinks fit;*
- *(c) apply, adopt or incorporate by reference, with or without modifications, any document relating to liquidity issued by the Basel Committee, whether in whole or in part and whether in force at the time of issue or as in force from time to time;*
- *(d) in respect of an AI incorporated in Hong Kong, specify, or empower the HKMA to specify, that any liquidity requirement rule applicable to the AI is to apply on the basis that the business of the AI includes all or any part of its business in or outside Hong Kong;*
- *(e) in respect of an AI incorporated in Hong Kong that has one or more than one associated entity within the meaning of section 97H(4), specify, or empower the HKMA to specify that any liquidity requirement rule applicable to the AI is to apply to the AI on an unconsolidated basis, to the AI and one or more of such entities on a consolidated basis, or both;*
- *(f) in respect of an AI incorporated outside Hong Kong, specify, or empower the HKMA to specify, that any liquidity requirement rule applicable to the AI is to apply only to the business of the AI in Hong Kong;*
- *(g) provide that a matter prescribed in the rules relating to an AI is a matter in respect of which the AI must immediately notify the HKMA and must provide particulars to the HKMA on request;*
- *(h) provide for the HKMA, on application made by an AI aggrieved by a decision of the HKMA, to review the decision;*
- *(i) prescribe a liquidity requirement in the form of a range with upper and lower limits, and the circumstances under which the HKMA may determine a specific liquidity requirement within that range to apply to an AI; and*
- *(j) contain incidental, supplementary, consequential, transitional or savings provisions that may be necessary or expedient in consequence of the rules*

97I(1)&(2) [3] "Prescribed notification requirement" means a requirement prescribed in the rules made under section 97H(1) to the effect that an AI must in respect of a matter prescribed in the rules immediately notify the HKMA. If, in compliance with a prescribed notification requirement, an AI notifies the HKMA of a failure to comply with a liquidity requirement rule relating to a minimum level of liquidity to be maintained by the AI, the HKMA must immediately notify the Financial Secretary and *provide the Financial Secretary with any particulars of the failure that the Financial Secretary requires.*

Pursuant to the Banking (Liquidity) Rules, those "relevant liquidity events" prescribed in rule 14(3) are subject to "prescribed notification requirement".

97J(1)&(2) [4] If the AI contravenes section 97H(6) then the HKMA and the AI will determine a remedial action plan which the AI will be required to follow.

97K(1) [5] The HKMA may vary any liquidity requirement rule applicable to a particular AI.

97M(1)&(2) [6] The HKMA may, after consultation with (a) the Banking Advisory Committee; (b) the Deposit-taking Companies Advisory Committee; (c) the Hong Kong Association of Banks and (d) the DTC Association, approve and issue any codes of practice (whether prepared by the HKMA or not) that the HKMA considers appropriate; or approve any codes of practice issued or proposed to be issued otherwise than by the HKMA that the HKMA considers appropriate.

13. Charges over assets

119A(2) Has *the* AI complied with the requirement that the sum total of all amounts secured by way of charge over its assets (excluding contra items) is less than 5% of the sum total of the value of those assets unless the HKMA has approved a higher amount?

Notes:

[1] This section does not apply to AIs incorporated outside Hong Kong.

119A(3) [2] The MA may, by notice published in the Gazette, specify a charge, or a class of charge, to which the above section does not apply.

14. Civil proceedings

119A(4) Has the AI any civil proceedings instituted against it which materially affect, or could materially affect, the financial position of the AI and which have not been notified to the HKMA?

Note:

This section does not apply to AIs incorporated outside Hong Kong.

APPENDIX 8
Examples of Modified Auditor's Assurance Reports

Example 1 – Section 63(3) report

The following example of a qualified report is for guidance only and is not intended to be exhaustive or applicable to all situations. It is based on Examples 1 and 2 in Appendix 1.

The situation where the auditor has identified errors to the institution's Returns but in the auditor's professional judgement, the effect of a matter is not so material and pervasive as to require an adverse conclusion; in this situation, the following wording would be adopted:

…

Auditor's Responsibilities

…

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Basis for Qualified Opinion

In respect of opinion below, we identified that [insert the errors] and the details are set out [in the appendix to this report][below].

Qualified Opinion

Based on the foregoing, in our opinion, except for the effect of the matter described in the Basis for Qualified Opinion section of our report, the Returns have been correctly complied, in all material respects, from the books and records of the Institution.

…

Example 2 – Section 63(3A) report

The following examples of modified reports are for guidance only and are not intended to be exhaustive or applicable to all situations. They are based on Example 3 and 4 in Appendix 1.

Option (i): The situation where the auditor has identified exceptions to the institution's systems of internal control for conclusion 1 but in the auditor's professional judgement, the effect of a matter is not so material and pervasive as to require an adverse conclusion; in this situation, the following wording would be adopted:

Basis for Qualified Conclusion

We identified exception[s] to the Institution's internal controls over [compilation of returns and information] / [compliance with its duties under [insert relevant sections of the Ordinance] / [maintenance of adequate provision for [insert relevant items referred to in section 63(3A)(a)(iii)] as set out in [the appendix to this report][below].

Qualified Conclusion

Based on the foregoing:

1. in our opinion, except for the effect of the matter described in the Basis for Qualified Conclusion section of our report, during the relevant period, the internal control systems examined by us, so far as these relate to matters referred to in section [63(3A)(a)] [63(3A)(a)(i) and (ii)]* of the Ordinance, were established and maintained, in all material respects, in accordance with the requirements set out in SPM IC-3; and

2. [#][during the relevant period,

   i. we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVIA or XVIB of the Ordinance;

   ii. we are not aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.] or

   [during the relevant period, we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIB of the Ordinance.]*

Option (ii): The situation where the auditor has identified exceptions to the institution's systems of internal control for conclusion 1 and in the auditor's professional judgement, the effect of a matter is so material and pervasive as to require an adverse conclusion; in this situation, the following wording would be adopted:

Basis for Adverse Conclusion

We identified exception[s] to the Institution's internal controls over [compilation of returns and information] / [compliance with its duties under [insert relevant sections of the Ordinance] / [maintenance of adequate provision for [insert relevant items referred to in section 63(3A)(a)(iii)] as set out in [the appendix to this report][below].

[#] The auditor should consider the implication on the conclusion 2 in respect of the exceptions identified for conclusion 1.

Adverse Conclusion

Based on the foregoing:

1. in our opinion, because of the significance of the matter described in the Basis for Adverse Conclusion section of our report, during the relevant period, the internal control systems examined by us, so far as these relate to matters referred to in section [63(3A)(a)] [63(3A)(a)(i) and (ii)]* of the Ordinance, were not established and maintained in accordance with the requirements set out in SPM IC-3; and

2. #[during the relevant period,

    i. we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV, XVIA or XVIB of the Ordinance;

    ii. we are not aware of any instances where the Institution has failed to maintain adequate provision for depreciation or diminution in the value of its assets (including provision for bad and doubtful debts), for liabilities which will or may fall to be discharged by it and for losses which will or may occur.] or

    [during the relevant period, we are not aware of any instances of material contravention by the Institution of any of its duties under Part XII, XV or XVIB of the Ordinance.]*

*Delete where not applicable

APPENDIX 9

Part A

Information maintained by management as an audit trail for adjustments made after a return is first submitted:

- Name of the Relevant Return
- Reference to the applicable line item(s) in the return
- Amount reported in the originally submitted return
- Amount relating to error(s) from compilation identified by management
- Reason for the error occurred and how management detected it
- Amount relating to financial statements / accounting books closing adjustment
- Description of the financial statements / accounting books closing adjustment
- Adjusted amount as reported in the Relevant Return

Part B

Summary of material errors identified by the auditor in the Relevant Return(s) submitted by AI on [Date] that is to be included in the auditor's report for section 63(3) reporting:

[Name of the Relevant Return]					
Reference in the Relevant Return	Description of the reported line item in the Relevant Return	Amount as reported in the Relevant Return	Material errors identified (HK$'000)	Adjusted amount (HK$'000)	Description of errors
		(A)	(B)	(C) = (A)+(B)	

APPENDIX 10

Guidance on "Two-tier" materiality approach

In evaluating whether or not an identified error is material for reporting under section 63(3) of the Ordinance, the auditor would need to consider both the quantitative and qualitative impact of the error on the Relevant Return. Such an impact could vary depending on the return being reviewed or the circumstances of the institution. For example, a small error could lead to a breach of a debt covenant limit on a prudential ratio for an AI. Hence the qualitative aspects would also need to be assessed by the auditor on a case-by-case basis. The "Two-tier" materiality approach described here focuses on both the quantitative and qualitative aspects of materiality considerations.

The "Two-tier" materiality approach considers materiality in two stages. A first-tier general quantitative benchmark (a difference of 5% or more to the particular line item in the return) and second-tier benchmarks determined quantitatively or qualitatively based on the main purpose of the return. For example, the total capital base or the total risk-weighted assets amounts are the key determinants of the capital adequacy ratio which is the focus of the Return of Capital Adequacy Ratio. Similarly, the broader classification of loan usage and loan quality under the five-grade loan classification system would be considered important for the Loans and Advances and Provisions Return.

In identifying the second-tier benchmarks, the auditor may consider factors such as the supervisory objectives and the focus of the return, the HKMA's reasons for selecting a particular return for examination, as well as findings from the HKMA or the auditor in respect of past submissions.

Depending on the circumstances of the institution, the HKMA may require a return other than the more common set of returns to be reported on under section 63(3) of the Ordinance. In such circumstances, it is recommended that the auditor seeks to discuss and understand from the HKMA and the AI the reasons for selecting the return and agree a materiality benchmark to assist in determining what should constitute a material error to be reported.

The table below sets out certain considerations to assist in determining materiality benchmarks for the more commonly examined returns under section 63(3) of the Ordinance. They are intended as a reference for the auditor to consider in exercising professional judgement which should take into account other factors described within this PN. Alternative benchmarks that the auditor develops for a particular engagement could be warranted and applied. In addition, the auditor should consider whether the errors identified are individually material or material in aggregate and the qualitative aspects of the errors. Any quantitative error identified should be considered with respect to the AI's size, risk profile, business activities and strategy in determining whether the identified error would be of major concern to the HKMA and hence warrant reporting under section 63(3) of the Ordinance. Material errors, regardless of their causal factors, should be reported to the HKMA. In this connection, the auditor should gather sufficient evidence to form such judgement.

Possible factors to be considered in determining the materiality benchmarks (non-prescriptive and non-exhaustive)

Returns	Possible considerations
Return of Capital Adequacy Ratio (“CAR”)	• The capital adequacy ratio ("CAR") is an important prudential measure that the HKMA uses to assess the capital adequacy position of a locally incorporated AI. AIs must meet the regulatory minimum CAR thresholds as set out in the Ordinance and by the HKMA. While the absolute amount of error identified may not be material quantitatively, if the error has resulted in a breach of regulatory minimum limits or requirements for different capital adequacy measures (e.g. Common Equity Tier 1 Capital Ratio, Tier 1 Capital Ratio, various Capital Buffer Ratios), the error will be considered as material qualitatively. Also, the materiality threshold should be adjusted downward when the relevant capital adequacy measures of the AI are close to the regulatory limits or requirements or the AI’s internal triggers. • As the CAR is calculated by dividing the capital base by risk-weighted assets, any material errors in either or both of these two components would be considered significant even if the overall impact of various errors may work to offset each other leading to only a small impact on the CAR. For example, there may be errors affecting both the numerator and denominator which offset each other leading to a largely unchanged CAR. Errors that materially affect the measurement and classification of different tiers of capital (i.e. Tier 1, Common Equity Tier 1, Additional Tier 1 and Tier 2) or risk-weighted amount of major items under different risk exposures (i.e. credit risk, market risk and operational risk) should therefore be reported. • For additional guidance, Appendix 10.1 of this PN has set out a list of reporting items that are typically considered important in the context of examining the CAR return for reference.
Return of Liquidity Position	• The liquidity ratio (LCR or LMR) is an important prudential measure that the HKMA uses to assess whether an AI maintains a sufficient level of liquidity to allow it to operate smoothly within the banking system. While the absolute amount of error identified may not be material quantitatively, if the error has resulted in a breach of regulatory minimum limit, the error will be considered as material qualitatively. In addition, the materiality threshold should be adjusted downward when the actual prudential ratio of the AI is close to the regulatory limit or requirements or the AI’s internal triggers. • The LCR is comprised of the numerator – “HQLAs” and the denominator – “expected cash inflows and outflows”. The LMR is comprised of the numerator – “liquefiable assets” and the denominator – “qualifying liabilities”. A material error in either or both the numerator or denominator will likely to be considered significant even if the overall impact of various errors may work to offset each other leading to only a small impact on the LCR or LMR. For example, there may be errors affecting both the numerator and denominator which offset each other leading to a largely unchanged LCR or LMR. Errors that materially affect the measurement and classification of different levels of HQLA (i.e. Level 1, 2A and 2B) and different liquidity inflow or outflow items (e.g. different types of secured lending transactions, stable and less stable deposits/funding) for LCR should therefore be reported. For additional guidance, Appendix 10.2 of this PN has set out a list of reporting items that are typically considered important in the context of examining the LCR return for reference. • Equally, errors that materially affect the measurement and classification of different categories of liquefiable assets and qualifying liabilities (e.g. those maturing within one month and over one month) before and after deductions for LMR should also be reported.

Possible factors to be considered in determining the materiality benchmarks (non-prescriptive and non-exhaustive) (Continued)

Returns	Possible considerations
Return of Large Exposures	• This return collects information on the AI's large exposures to banks, non-bank entities and connected parties which, in turn, is a reflection of the concentration risk of the AI. Error that significantly shifts the large exposures concentration distribution will likely be considered as material. Errors which are considered as immaterial with reference to the total top ten exposures but are in fact material for exposures to any individual counterparty will also warrant reporting by the auditor. • The HKMA requires the top ten counterparties to be reported in order to allow it to understand an AI's concentration risk and for its analytical purposes. It is therefore important to ensure that the top ten counterparties reported are the correct set of counterparties with their amount of exposures accurately captured and ranked. • If an error has resulted in a breach of the AI's internal or regulatory large exposures limit, such an error will be considered material even if the absolute amount of the error may not be material quantitatively.
Return of Loans and Advances and Provisions	• This return analyses, by economic sector, an AI's loans and advances for use in Hong Kong. It also analyses the performance of an AI's selected assets (mainly loans and advances) and off-balance sheet exposures according to the classification methods defined in the completion instructions. The information serves a statistical purpose as well as a prudential purpose allowing the HKMA to assess any particular concentration from an industry segment perspective. An error that significantly shifts any of the major industry segment distribution will likely be considered as material. • Similarly, errors that materially affect the different categories of loan classification and provisions, overdue and rescheduled assets, details of ten largest exposures in each of the criticized asset grades should also warrant reporting by the auditor.
Return of Mainland Activities	• This return collects information on the Mainland-related business activities of an AI and their Mainland bank subsidiaries by various classification measures. Given the importance of the Mainland China economy to the Hong Kong banking sector, this allows the HKMA to monitor changes in an AI's exposure to the Mainland-related business activities. Error that significantly shifts the concentration distribution of the exposures under various sections of the return will likely be considered as material. • Similarly, errors that materially affect the major categories of balance sheet and profit and loss items and non-bank Mainland China exposures to different: a. types of counterparties; b. geographical locations in Mainland China; c. major economic sector categories; d. loan classification categories; e. risk mitigation types; and details of the top ten non-bank Mainland China exposures should be reported.

APPENDIX 10.1

Return of Capital Adequacy Ratio (“CAR”)

The following reporting items are typically considered important in the context of examining the CAR return. Material errors in these reporting items would normally warrant reporting by the auditor. These reporting items include:

1. Capital Base

i. Tier 1 Capital
   - Common Equity Tier 1 (“CET1”) Capital before and after deductions
   - Additional Tier 1 Capital before and after deductions

ii. Tier 2 Capital before and after deductions

iii. Total Capital

2. Risk Weighted Amount (“RWA”)

i. Total risk weighted amount for credit risk (Basic (“BSC”) Approach) for On-balance sheet and Off balance Sheet Exposures

ii. Total RWA for credit risk (Standardized (Credit risk) (“STC”) Approach) for On-balance sheet and Off balance Sheet Exposures

iii. Total RWA for credit risk (Internal ratings-based (“IRB”) Approach) for On-balance sheet and Off balance Sheet Exposures by IRB Class / Subclass

iv. Total RWA for credit risk for exposures to Central Counterparties (“CCP”)

v. Total RWA for credit risk for advanced / standardized Credit Valuation Adjustment (“CVA”) method (only for AIs not using IRB approach)

vi. Total RWA for credit risk under STC (Securitization) Approach / IRB (Securitization) Approach

vii. Total RWA for market risk

viii. Total RWA for operational risk

ix. Total additional RWA due to application of capital floor (only for AIs using IRB Approach)

x. Total deductions to RWA

3. Common Equity Tier 1 Capital Ratio

4. Net CET 1 Ratio

5. Tier 1 Capital Ratio

6. Total Capital Ratio

7. IRB coverage %

8. Capital Buffer Requirements - Buffer level %

which is the sum of:

i. Capital conservation buffer ratio %

ii. Countercyclical capital buffer ratio %

iii. Higher loss absorbency ratio %

APPENDIX 10.2

Return of Liquidity Position - Liquidity Coverage Ratio ("LCR")

The following reporting items are typically considered important in the context of examining the LCR return. Material errors in these reporting items would normally warrant reporting by the auditor. These reporting items include:

1. **Weighted amount of High Quality Liquid Assets ("HQLA")**

   i. Total Level 1 assets (before deductions)
   ii. Total Level 2A assets (before deductions)
   iii. Total Level 2B assets (before deductions)
   iv. Deductions to weighted amount of HQLA
   v. Total HQLA (after deductions)

2. **Weighted amount of Expected Cash Outflows**

   i. Retail deposits (stable, less stable and term)
   ii. Small business funding (stable, less stable and term)
   iii. Operational deposits
   iv. Unsecured wholesale funding (other than small business funding)
   v. Debt securities and prescribed instruments issued by the reporting institution and redeemable within the LCR period
   vi. Secured funding transactions (other than securities swap transactions)
   vii. Securities swap transactions
   viii. Contractual net cash outflows arising from derivatives contracts and other transactions, and additional liquidity needs arising from related collateral requirements
   ix. Cash outflows arising from obligations under structured financing transactions and repayment of funding obtained from such transactions
   x. Potential drawdown of undrawn committed facilities (including committed credit facilities and committed liquidity facilities)
   xi. Contractual lending obligations (not otherwise covered above) and other contractual cash outflows
   xii. Other contingent funding obligations (whether contractual or non-contractual)
   xiii. Total expected cash outflows

3. **Weighted amount of Expected Cash Inflows**

   i. Secured lending transactions (including securities swap transactions)
   ii. Secured and unsecured loans (other than secured lending transactions)
   iii. Operational deposits placed at other financial institutions
   iv. Other contractual cash inflows
   v. Total expected cash inflows (after application of 75% inflow ceiling)

4. **Liquidity Coverage Ratio (LCR) %**

APPENDIX 11

Suggested procedures pertaining to specific returns

The auditor would ensure that appropriate procedures are designed and carried out to gain adequate assurance that the returns are compiled correctly from the books and records. The specific compilation procedures of each return would vary depending on the requirements of particular return as set out in the completion instructions and other guidelines issued by the HKMA. The auditor would perform tests on the compilation procedures to determine whether they meet the requirements of completion instructions and relevant guidelines issued by the HKMA. Particular areas which the auditor would take into consideration in examining returns which normally fall within the scope for reporting under section 63(3) are highlighted below for reference purposes:

a. *Capital Adequacy*

- Check that reserves have been appropriately classified under the categories of "Common Equity Tier 1 capital" ("CET1 Capital") and "Tier 2 capital";

- Perform checks as to whether the amounts and nature of capital items recognized as "regulatory capital" are in accordance with the limits and any specific guidance on criteria established by the HKMA in the completion instructions and in the HKMA's Supervisory Policy Manual and other guidelines in respect of "regulatory capital";

- Perform checks as to whether the specified items are deducted from the CET1 capital, Additional Tier ("AT") 1 capital and Tier 2 capital in accordance with the completion instructions;

- Check that the AI has properly calculated the Net CET1 capital ratio and the buffer level in accordance with the completion instructions;

- Check that the AI has properly calculated the risk-weighted amount for credit risk, market risk and operational risk in relation to its on- and off-balance sheet exposures as the case requires, taking into account the relevant criteria, such as the type of instrument or exposure, the nature of counterparties, the maturity of the exposure and the approach it adopts to calculate the capital requirements for those exposures.

- With respect to certain items that need to be reported by the AI based on approach as agreed with the HKMA (such as the IRB Approach for calculating the risk weighted amount for credit risk and the IMM approach for calculating the risk weighted amount for market risk), the auditor is expected to carry out procedures to ensure that relevant established methodologies, including those key assumptions identified by management, have been applied in determining the amounts of such items for reporting in the return. As part of section 63(3A) work, the auditor would also consider the governance and control framework around the review and application of such methodologies and assumptions. Certain elements of such control framework could be tested as part of the section 63(3) work procedures if relevant controls are relied upon (e.g., testing the logical access controls around changing assumptions or inputs to a model). It should be noted, however, the objective and scope of such work procedures is not intended to address the appropriateness or suitability of these key assumptions, systems and methodologies. Accordingly, the auditor's opinion in section 63(3) report would not provide assurance over the appropriateness or suitability of these key assumptions, systems and methodologies applied by management.

b. Large Exposures

- Obtain an understanding of how the AI captures and reports its large exposures to banks, non-bank entities and connected parties, and of the controls and processes operated by the AI to identify the linked counterparties;

- Obtain a list of connected parties (as defined in the completion instructions) and perform procedures to ascertain completeness;

- Perform checks that counterparties which are linked in a way that the financial soundness of one may affect the financial soundness of another are identified and that exposures to such counterparties are captured and aggregated for reporting purposes;

- Perform checks on individual exposure amounts to determine whether on-balance sheet exposures, off-balance sheet exposures, default risk exposures and any other risk exposures which may cause material impact on the AI's concentration risk, are captured and whether indirect exposures (e.g. guarantees granted by the counterparty) are also appropriately identified and reported;

- Perform checks as to whether exposure amounts (aggregating all facilities) for individual counterparties or groups of linked counterparties have been captured on a daily basis and that the maximum exposure is identified from the daily reported exposures;

- Review the nature of counterparties or groups of linked counterparties and assess the appropriateness of classification within the relevant parts of the return.

c. Liquidity

- The LCR introduced in liquidity regulations in January 2015 applies to AIs designated by the HKMA (in accordance with Rule 3 of the Banking (Liquidity) Rules) as "category 1 institutions". All other AIs not designated by the HKMA as category 1 institutions are required to comply with the LMR requirements (category 2 institutions);

- For category 1 institutions under the LCR framework:

  - Obtain an understanding of how the AI recognizes relevant assets as HQLAs, and reports expected cash inflows and outflows (with the latter including both contractual and non-contractual cash outflows) in accordance with the criteria set out in the Banking (Liquidity) Rules, the Code of Practice[21] and the completion instructions;

  - Perform sample checks as to whether various types of HQLAs, expected cash inflows and outflows have been appropriately classified according to their nature, and that they qualify for inclusion as HQLAs, expected cash inflows and outflows according to criteria set out in the Banking (Liquidity) Rules, the Code of Practice and the completion instructions;

[21] This refers to the "Code of Practice for the Purposes of Providing Guidance in Respect of the Provisions of Division 5 (Calculation of Total Net Cash Outflows) of Part 7 of the Banking (Liquidity) Rules", which is issued by the HKMA in December 2014 under section 97M of the Banking Ordinance.

- With respect to certain expected cash flow items (such as "operational deposits", "potential drawdown of undrawn committed facilities" and "non-contractual contingent funding obligations") that need to be reported by category 1 institutions based on certain estimation methodologies as required by the HKMA, auditors are expected to carry out procedures to ensure that relevant established methodologies, including those key assumptions identified by management, have been applied in determining the amounts of such expected cash flow items for reporting in the return. As part of section 63(3A) work, the auditor would also consider the governance and control framework around the review and application of such methodologies and assumptions. Some of the elements of such control framework could be tested as part of the section 63(3) work procedures if relevant controls are relied upon (e.g., testing the logical access controls around changing assumptions or inputs to a model). It should be noted, however, the objective and scope of such work procedures is not intended to address the appropriateness or suitability of these key assumptions, systems and methodologies. Accordingly, the auditor's opinion in section 63(3) report would not provide assurance over the appropriateness or suitability of these key assumptions, systems and methodologies applied by management.

- For category 2 institutions under the LMR framework:

  - Obtain an understanding of how the AI recognizes relevant assets and liabilities as "liquefiable assets" and "qualifying liabilities (after deductions)" according to the criteria set out in the Banking (Liquidity) Rules and the completion instructions;

  - Perform sample checks to ascertain whether various types of liquefiable assets and qualifying liabilities (after deductions) have been appropriately classified according to their nature, the remaining term to maturity, and that they qualify for inclusion as liquefiable assets and qualifying liabilities (after deductions) according to the criteria set out in the Banking (Liquidity) Rules and completion instructions;

  - With respect to certain types of "other one-month liabilities" (such as "irrevocable commitments") that need to be reported by category 2 institutions based on certain estimation methodologies as required by the HKMA, the auditor is expected to carry out procedures to ensure that relevant established methodologies, including any key assumptions identified by management, have been applied in determining the amounts of such liability items for reporting in the return. It should be noted, however, that the auditor's opinion in section 63(3) report would not address the appropriateness or suitability of such assumptions and methodologies. (Please also refer to the guidance provided in the 3rd bullet for category 1 institutions above.)

  - Confirm with the AI whether the HKMA has given approval to the AI to calculate the monthly "average LMR" (to be reported under Section (II) in Part 3 of the return) on the basis of specified days during the month and perform checks as to whether the AI calculates the ratio on the basis agreed with the HKMA.

- For the purpose of calculating the lowest LCR or LMR during the month, perform checks to ascertain whether the AI determines the ratio as the lowest LCR or LMR recorded at the close of business on all working days during the month covered by the return.

d. Compliance

- Check that the capital base reported agrees to the amount reported in the Return of Capital Adequacy Ratio at the previous quarter end*;

- Perform checks on the collateral records maintained by the AI to determine whether the shares of the AI, its holding, subsidiary or fellow subsidiary companies are held as security for loans and other credit facilities;

- Perform checks on compliance with the requirements under sections 80, 81*, 83*, 85*, 87A*, 88* and 119A*, as well as Part 2 of the BELR, during the reporting period. With effect from 13 July 2018, sections 87 and 90 were repealed and BELR has come into effect on that date[22];

- Obtain correspondence setting out the capital and liquidity requirements prescribed by the HKMA for the AI for the purpose of compliance with sections 97C(1) as varied by section 97F(1)* and 97H(1)) as varied by section 97K(1);

- For item 9 under Part II of the MA(BS)1F(a) return* (or item 2(c) of the MA(BS)1F(b) return for AIs incorporated outside Hong Kong) on minimum liquidity requirements during the reporting period, perform checks on compliance with the minimum liquidity requirements of LCR and NSFR under rule 4, rule 8A and 8B of the Banking (Liquidity) Rules respectively for category 1 institutions. Where applicable, perform checks on compliance with the minimum liquidity requirements of LMR under rule 7 of the Banking (Liquidity) Rules for category 2 institutions and the minimum CFR under rule 8D of the Banking (Liquidity) Rules for category 2A institutions.

- For items 1-7 under Part III of the return, check that daily closing exposures were used in reporting the maximum exposure and that the amount reported excludes those items which are exempted under sections 81, 83 and 88* or Rule 13 of the BELR. With effect from 13 July 2018, section 87 was repealed and BELR has come into effect on that date[22];

- Check the calculations for the maximum ratio of pledged assets and ensure the amounts used are correctly extracted from the AI's register of charges or other appropriate books and records*;

- Review legal correspondence for civil proceedings which may have a material impact on the financial position of the AI and confirm with management that it has notified the HKMA of any such proceedings*.

** applicable for locally incorporated AIs only*

e. Quarterly Analysis of Loans And Advances And Provisions

- Obtain an understanding of how the AI captures and reports its loans and advances and provisions in the appropriate assets category in Part 1 - Loans and advances and provisions and various on-balance sheet assets and off-balance sheet contingencies items according to the loan classification system in Part 2 - Loan classification and provisions according to the completion instructions;

- For AIs whose internal classification system is different from the HKMA five-grade loan classification system, understand and evaluate the internal classification system of the AI and the methodology for mapping the internal classifications to the HKMA’s loan classifications for the purpose of reporting to the HKMA;

- Perform sample checks on individual loans and advances items to determine whether these items are properly classified based on their loan usage as loans and advances for use in Hong Kong, trade financing loans and other loans and advances. For loans and advances for use in Hong Kong, perform further sample checks on the classification of the individual loans and advances items to each economic sector;

[22] Please note that if the scope of sections 63(3) and/or 63(3A) reporting covers the periods up to 12 July 2018, sections 87 and 90 of the Banking Ordinance are still applicable for those periods up to 12 July 2018.

- Check that provisions made have been appropriately classified into specific provisions and general provisions and correctly reported;

- Perform sample checks as to whether loans and advances, balances due from banks, acceptances and bills of exchange held, investment debt securities and commitments and contingent liabilities of similar nature into the categories have been properly classified according to the loan classification system and whether the loan classifications are properly determined in accordance with the HKMA's loan classification system;

- Check that the AI has properly captured and reported the required amounts for any of the notes under Note (1) to Note (7) that are within the scope of section 63(3) reporting. For Note (3) – Overdue and rescheduled assets, check that the AI has properly identified and classified the assets according to their nature to report these assets as overdue and rescheduled in accordance with the completion instructions.

f. *Mainland Activities*

- Obtain an understanding of how the AI captures and reports the balance sheet and profit and loss account for position of its subsidiary bank(s) in Mainland China and the non-bank Mainland China exposures with their related breakdowns (i.e. breakdown by type and counterparty, geographical location in Mainland China, economic sector, loan classification and risk mitigation type) according to the criteria set out in the completion instructions;

- With respect to the balance sheet and profit and loss account for position of its subsidiary bank(s), obtain the trial balance(s) of its subsidiary bank(s) and check the appropriateness on the mapping of the accounts in the trial balances to the reportable items in the return according to the criteria set out in the completion instructions;

- With respect to non-bank Mainland China exposures counterparties' type, geographical location, economic sector, loan classification and risk mitigation type, the auditor is expected to perform appropriate procedures to ensure that relevant established classification methodologies, including any key assumptions adopted by management, have been applied in determining the amounts of such exposures for reporting in the return. As part of the examination under section 63(3A) of the Ordinance, the auditor would also consider the governance and control framework around the review and application of such methodologies and assumptions.

- Perform sample checks to ascertain whether various breakdowns of non-bank Mainland China exposures have been appropriately classified according to their type and counterparty, geographical location in Mainland China, economic sector, loan classification and risk mitigation type; and

- With respect to top ten largest non-bank Mainland China exposures and ten largest exposures to PRC nationals residing in Mainland China or entities beneficially-owned by Mainland interest:

  - Obtain an understanding of how the AI captures and reports large exposures; and

  - Perform sample checks on individual exposure amounts to determine whether on-balance sheet exposures and off-balance sheet exposures are appropriately identified and reported.