
QUALITY ASSURANCE



Embracing Changes

2019 Annual Report



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

CONTENTS

Foreword	2
Oversight of our work	4
Our work and review outcomes	
Practice review programme	5
Professional standards monitoring programme	14
Our findings	
Practice review programme	19
Professional standards monitoring programme	40
Communication with members	77
Annex:	
Members of the Regulatory Oversight Board in 2019	78
Members of the Practice Review Committee in 2019	79
Members of the Professional Standards Monitoring Expert Panel in 2019	80
Independent Reviewers of the Professional Standards Monitoring Programme in 2019	81

Foreword

2019 was not only an eventful year for Hong Kong but also for our practice review programme. This report sets out information about our work results as well as the changes introduced to our practice review and professional standards monitoring programmes in 2019.

The most fundamental development over the past year was the enactment of the Financial Reporting Council (Amendment) Ordinance (“FRC(AO)”) that took effect on 1 October 2019. The ordinance gives the Financial Reporting Council (“FRC”) the powers to carry out inspections of public interest entity (“PIE”) audit engagements completed by PIE auditors on or after 1 October 2019. As a result of this change, we issued Alert No. 31 notifying practising members about the changes in the practice review scope and selection criteria under our practice review programme. Practice units are now identified as one of four categories based on their number of audit clients, regulatory clients and practising partners or directors. Firms in higher categories will be visited more frequently. As practice units with listed clients will be visited both by the FRC and us in future, we will continue to liaise with the FRC about developing a protocol to avoid duplication of work and minimize the disturbance caused to practices.

In 2019, we continued to work towards our target of achieving a six-year review cycle for all practices. We carried out 354 practice reviews of practice units with audit clients, an increase of 15% from 2018. The Practice Review Committee considered 374 practice review reports in 2019. The percentage of directly closed cases had improved slightly from 61% to 65%. The number of complaint or referral to the FRC cases however increased, standing at 18, including 9 cases relating to practices with listed clients – although the reviews of the complaint or referral cases against practices with listed clients were conducted over two years. The increase does however indicate that the technical ability and resources needed for listed company audits are far beyond what some practices had anticipated. Complaints were also raised against 3 practices subject to first time practice reviews. Practices are advised not to wait until a practice review takes place before taking actions to address any deficiencies they identify, including those frequently communicated deficiencies, in their practice.

Following on from the launch of our Anti-Money Laundering and Counter-Terrorist Financing (“AML / CTF”) Compliance Monitoring Review (“ACMR”) programme in October 2018, we have gradually extended our ACMRs not only to practices with audit clients but also to those without. We set up a dedicated ACMR team to provide support to our reviews and the future development of the programme. In 2019, we carried out 317 ACMRs as part of the practice reviews of practices with audit clients and 34 separate ACMRs of practices without audit clients. No regulatory actions have so far been taken as a result of practice review findings. As sufficient time has now passed for practices to put in place an adequate AML / CTF compliance system, it is expected that more rigorous actions will be taken as a result of non-compliance found in ACMRs in the future.

In 2019, we again referred 5 cases to the Mainland Ministry of Finance (“MOF”) for review. We also asked the MOF to help clarify the processes required to enable practices to take audit files outside the Mainland for our practice reviews. We thank the MOF for their assistance and hope to be able to move forward with access to Mainland working papers issue in a mutually agreed way in the nearest future.

With regard to professional standard monitoring, two new major standards were our review focus for 2019. Effective for financial statements for annual periods beginning on or after 1 January 2018, HKFRS 15 *Revenue from Contracts with Customers* and HKFRS 9 (2014) *Financial Instruments*, require significant changes in the accounting for revenue and financial instruments and extensive disclosures of the resulting changes and their application. Although no major non-compliance was identified, we consider there is room for improvement of various disclosures such as regarding significant judgements made in applying HKFRS 15 and the amended credit risk disclosures required by HKFRS 7 *Financial Instruments Disclosures* for financial instruments to which the impairment requirements in HKFRS 9 apply. In our reviews, we also identified disclosure deficiencies in relation to other standards including HKAS 36 *Impairment of Assets*, HKFRS 3 *Business Combinations* and HKFRS 13 *Fair Value Measurement*.

Despite the FRC having taken on the regulations of listed company audits, we see benefits in continuing to carrying on the professional standards monitoring function. The function has been in existence for more than 30 years and is useful for the Institute's post-implementation review of professional standards. Accordingly, we will retain this programme and continue to refer non-compliance matters identified under this programme to the FRC in future.

We once again thank members for their support of our programmes. Despite the changes in our responsibilities, we will continue to work hard to ensure quality of work carried out by practices commands public trust and confidence and meets latest legislative requirements.

Regards

Elsa Ho

Director, Quality Assurance

April 2020

Oversight of our work

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

The responsibility for oversight of QAD activities rests with the Regulatory Oversight Board (“ROB”) which oversees all the regulatory functions of the Institute.

The ROB ensures that QAD activities are carried out in accordance with strategies and policies determined by the Council of the Institute and in the public interest. The oversight work includes receiving and reviewing annual work plans and budgets and regular progress reports from management and reporting to the Council on observations and views in relation to performance and operations. Please refer to Annex for members of the ROB.

Our work and review outcomes – Practice review programme

Practice review is a quality assurance programme that monitors all the Institute's practice units, including individual practising certificate holders, firms and corporate practices, to determine whether they have observed, maintained or applied professional standards. The Professional Accountants Ordinance ("PAO") has empowered the Institute to carry out practice review since 1992. The approach to practice review was revised in 2006 to bring it up to international standards and it is regularly amended to maintain best practice.

The Institute's practice review programme consists of two elements: the usual audit quality assurance reviews and the new Anti-Money Laundering and Counter-Terrorist Financing ("AML / CTF") Compliance Monitoring Reviews ("ACMRs").

Prior to October 2018, the Institute's practice reviews covered solely audit quality assurance reviews to determine whether practices have observed, maintained or applied the professional standards, including all the statements and guidelines of professional ethics, financial reporting standards and standards on auditing and assurance. Following on from the introduction of the amended Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) ("AMLO") that extended the scope of the legislation to cover designated non-financial businesses and professions, including accounting professionals, the Institute took on the supervisory responsibilities for AML/CTF compliance by accounting professionals with effect from 1 March 2018. In October 2018, the Institute launched an ACMR programme within its practice review programme to monitor the level of compliance of the Institute's practice units with the Guidelines on AML/CTF for Professional Accountants ("AML Guidelines") included as part of the Institute's Code of Ethics.

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

Our work

Process

The process of a practice review (included an ACMR) or a separate ACMR can be divided into three stages:

Stage 1 – Preparation

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

Stage 2 – On-site visit / inhouse desktop review

- Opening meeting*
- Conduct interviews*
- Review compliance with HKSQC1 and review selected audit files (not applicable to a separate ACMR)
- Review compliance with AML Guidelines and selected customer due diligence (“CDD”) documents, if applicable
- Summarize findings and recommendations
- Exit meeting*

* These procedures, if needed, are carried out by telephone for desktop reviews

Stage 3 – Reporting

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

Practice selection

Selection of practices for review is based on their risk profiles, developed using information obtained from the electronic self-assessment questionnaire (“the EQS”) and other relevant sources.

Before 1 October 2019, the frequency of reviews of each type of practices was as follows:

Practices	Frequency of review
Big Four	Annually
Practices with a significant number of listed clients	Subject to a full review at least every three years and an interim review during the three-year cycle
Other practices with listed clients	Subject to a full review at least every three years and an additional interim review if certain risk factors exist
Other practices	Based on risk profiles and random selection

On 1 October 2019, the Financial Reporting Council (Amendment) Ordinance (“FRC(A)O”) took effect, giving the Financial Reporting Council (“FRC”) more powers to regulate auditors of listed companies in Hong Kong. Since then, the FRC has taken on the responsibilities for inspection of PIE engagements completed by PIE auditors on or after 1 October 2019. The Institute’s practice review programme continues to cover all active practices but its remit has changed to regulation of non-PIE engagements and AML/CTF compliance.

Following the above change, the Institute continues to apply a mixed risk-based-cycle approach for selection of practices for reviews. Within that approach, the Institute retains its goal to review all active practices at least every 6 years. The frequency of practice reviews of practices with audit and assurance clients (AA clients) will be shortened based on the following factors:

1. Size – based on the number of non-PIE AA clients^{Note} and practising partners or directors
2. Complexity – based on the number of regulated non-PIE AA clients^{Note}.

Note:

Non-PIE AA clients are AA clients whose engagements fall outside the definition of PIE engagements specified in FRC(A)O and therefore are included in the scope of the Institute’s practice review programme. Non PIE-AA clients included in the following categories are considered regulated non-PIE AA clients for the above purpose:

- a. “authorized institutions” as defined under the Banking Ordinance
- b. “insurers” as defined under the Insurance Ordinance
- c. “insurance brokers” as defined under the Insurance Ordinance
- d. “licensed corporations” and “associated entities” as defined under the Securities and Futures Ordinance

Based on these factors, all active practices with AA clients are separated into categories and will be subject to practice reviews by the Institute according to the following review frequencies:

	Practices	Frequency of review
Standard	With 500 or fewer non-PIE AA clients and with 10 or fewer regulated non-PIE AA clients	6 year cycle (ultimately when achievable based on resources available)
Tier 1	With more than (i) 500 non-PIE AA clients or (ii) 10 regulated non-PIE AA clients	3 year cycle
Tier 2	With more than (i) 1000 non-PIE AA clients and (ii) 10 regulated non-PIE AA clients	1.5 year cycle
Tier 3	With more than (i) 1000 non-PIE AA clients; (ii) 20 regulated non-PIE AA clients and (iii) 50 practising partners or directors	Annually

Practice reviews of practices without AA clients are subject to separate ACMRs normally on a six-year review cycle basis. The frequency of the ACMRs on these practices will be shortened if a large proportion of their activities involve specified transactions as defined in the AML Guidelines.

As well as the above factors, other practice-specific information will be considered when determining the review frequency of individual practices. These factors include:

1. Previous regulatory history – based on past practice review results and regulatory actions taken by the Institute and other regulators
2. Other risk factors identified through the Institute’s regulatory system
3. A small number of reviews randomly selected every year

Audit quality assurance reviews

The scope of an audit quality assurance review includes obtaining an understanding of the practice’s system of quality control, assessing compliance with HKSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* and the practice’s policies and procedures, and reviewing completed audit engagements. The extent of review work that the QAD carries out varies from practice to practice depending on the size of the practice and the nature of its client base.

Desktop reviews are carried out for small practices with no predetermined risk factors. Desktop reviews take place at the Institute’s office and comprise a review of the latest monitoring report and one audit engagement. An initial self-evaluation process is included as part of the desktop reviews for low risk practices with only a handful of private audit clients.

ACMRs

The scope of an ACMR includes obtaining an understanding of the practice’s relevant AML/CTF policies and procedures and inspecting documentary evidence to assess level of compliance with the AML Guidelines and relevant laws and regulations.

There are two types of ACMR, namely a full-scope ACMR and a desktop ACMR. Practices which have prepared for or carried out for clients transactions specified in Paragraphs 600.2.1 and 600.2.2 of the AML Guidelines (“Specified Transactions”) will be subject to a full scope ACMR. Other active practices will be subject to a desktop ACMR.

In order to make best use of resources and to cause less disturbance to practices, an ACMR has been included within every full scope and desktop practice review carried out on a practice with AA clients since October 2018 and April 2019, respectively. Separate ACMRs are arranged for practices without AA clients. Full scope separate ACMRs are carried out on site whereas desktop separate ACMRs take place in the Institute’s office.

The Financial Action Task Force (“FATF”) recommended in its mutual evaluation report on Hong Kong (September 2019) that the Institute, as the regulatory body of accounting professionals defined in the AMLO, should continue to develop an assessment of sectoral money laundering and terrorist financing risks at the individual institutional level and a more robust risk-based supervisory plan. In addition, the Institute was recommended to conduct appropriate monitoring and follow-up to ensure compliance by accounting professionals (defined in AMLO as certified public accountants as well as practice units) with AML / CTF requirements. In response to the FATF’s comments, the Institute will proceed to developing a more proactive risk-based supervisory plan to monitor AML / CTF compliance by accounting professionals, not only practice units, and details will be communicated in due course.

Reporting

The QAD is responsible for drawing conclusions and making recommendations to the PRC for consideration and decisions. The PRC having regard to the report and any response by the practice to the matters raised in the report may act under the power given by the PAO, to:

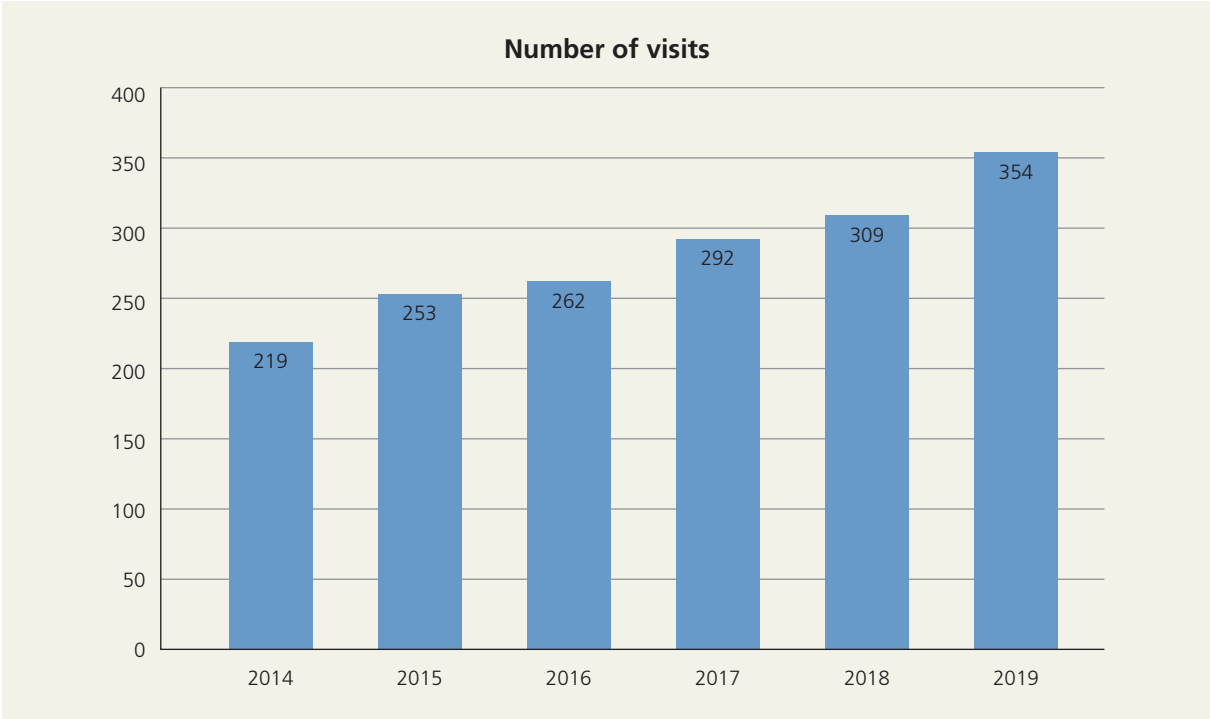
- conclude a practice review with no follow up action required (“direct closed”);
- make recommendations and specific requests to a practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings (“required follow up action”);
- instruct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

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

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

Our review outcomes

The number of practice reviews carried out each year has increased from 219 in 2014 to 354 in 2019.



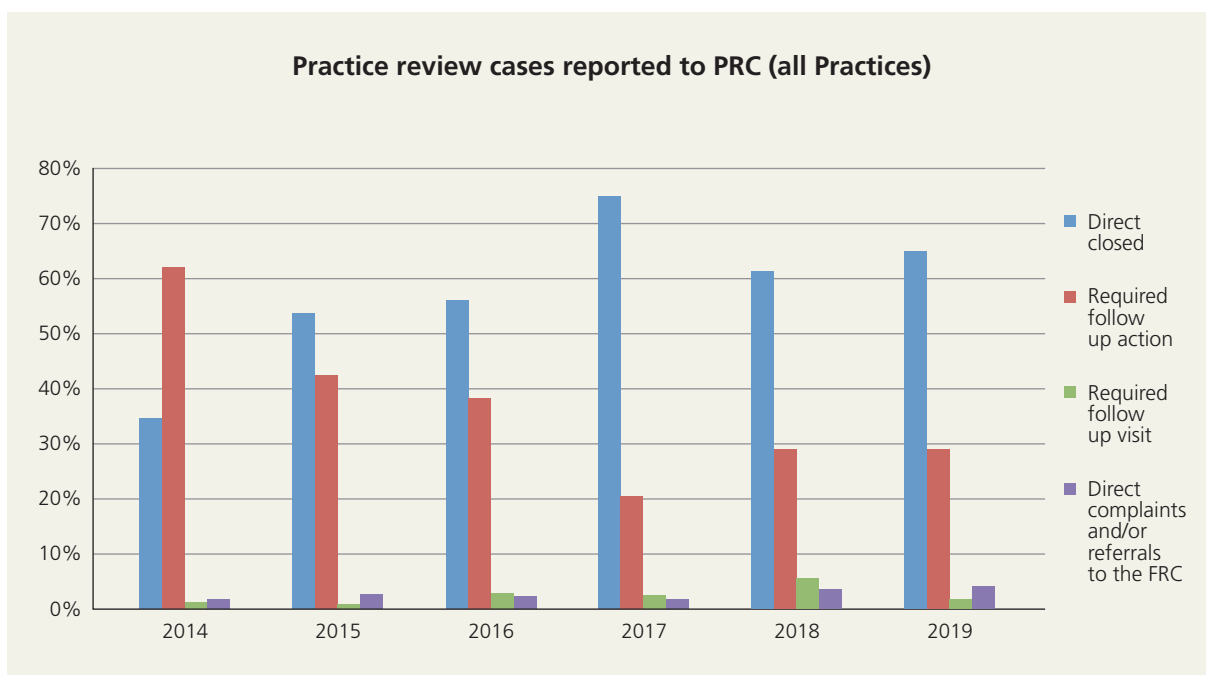
In 2019, 317 ACMRs were included within the practice reviews above. In addition, separate ACMRs were conducted on 34 practices.

Work progress in 2019

The PRC met on eleven occasions in 2019 and considered 374 practice review reports and eight separate ACMR reports.

The PRC concluded that 233 initial visits and eight ACMRs should be closed without requiring any follow up actions. For 105 initial visits, practices were required to undertake specific remedial actions and / or submit a status report on actions taken in response to practice review findings. Six reviews required a follow up visit to assess the effectiveness of remedial actions taken. Eleven reviews including six practices with listed clients proceeded to complaints. Three reviews resulted in referrals to the FRC.

Sixteen follow up visits were reported to the PRC in 2019. Seven follow up visits were closed on the basis that adequate remedial actions had been taken, five required further follow up actions, and four proceeded to complaints.



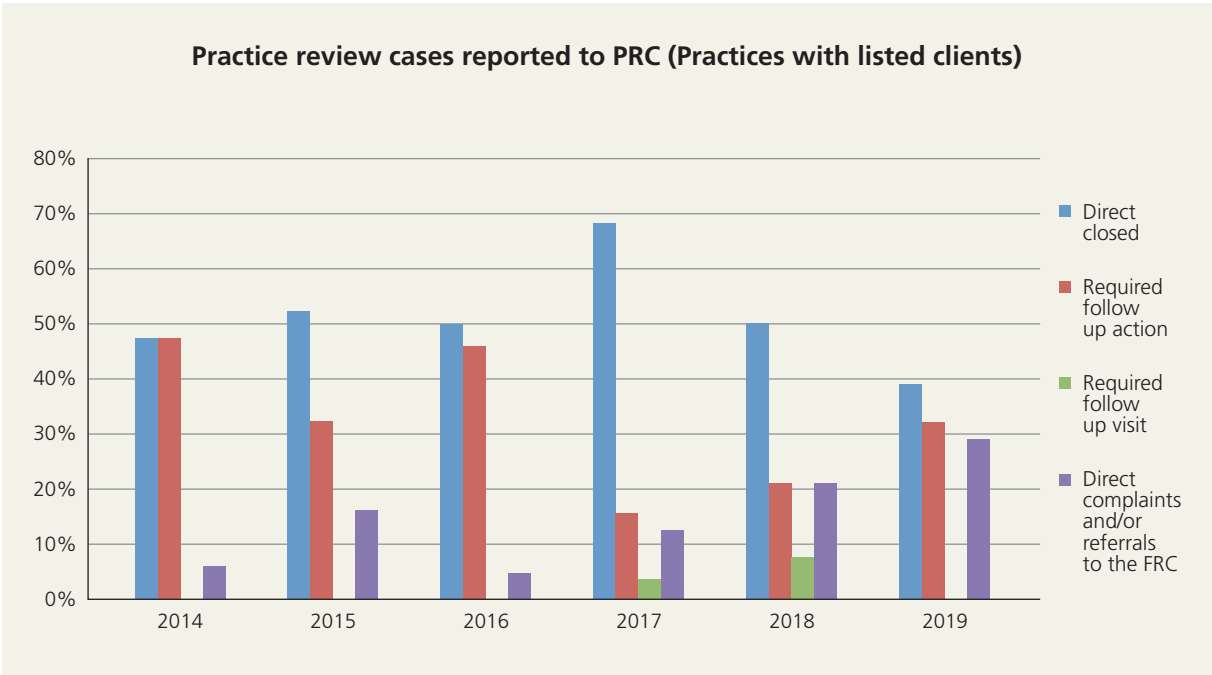
Practices with listed clients

For practices with listed clients, directly closed reviews have decreased from 50% in 2018 to 39% in 2019 while reviews requiring follow up action have increased from 21% in 2018 to 32% in 2019. The review outcomes indicate the need for improvement in audit quality.

In 2019, the PRC decided to raise direct complaints against six practices based on reviews due to significant deficiencies, including failings to obtain sufficient evidence or perform sufficient appropriate audit work on significant items / issues, e.g. impairment assessments of goodwill and assets, valuation of intangible assets, convertible notes and financial assets, in the audit of listed clients.

In addition, three listed entity audits of three other practices based on reviews taken place over two years were referred to the FRC for further investigation. In these cases, the auditors either failed to identify the accounting mistakes made in the financial statements of the client or did not adequately assess the appropriateness of the client’s accounting treatments concerning certain key items / transactions, e.g. deemed disposal of subsidiaries, impairment of assets, etc.

The results of reviews suggest that audits of listed entities demand a much higher level of resources and technical knowledge than some of the practices had anticipated.



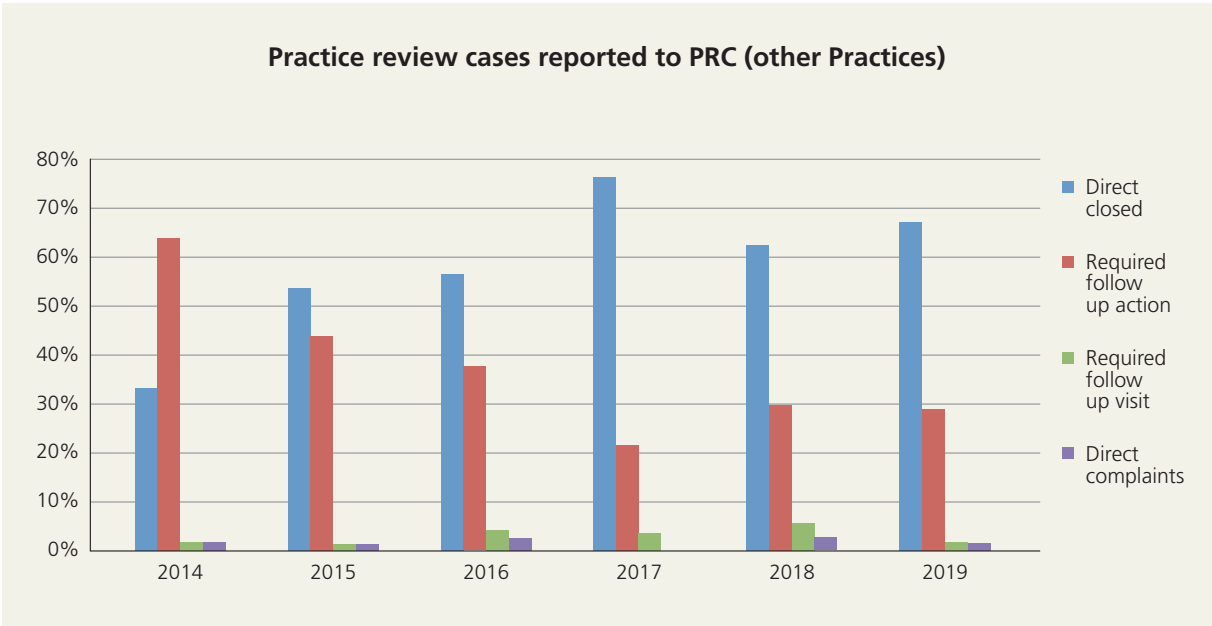
Practices without listed clients

The review outcomes practices without listed clients improved slightly in 2019. 68% of the reviews of practices without listed clients were directly closed in 2019, representing an increase of 6% from 2018. The reviews that required follow up action have decreased from 30% in 2018 to 29% in 2019. The changes reflect that practices are generally responsive to practice review findings.

Where findings identified in a first time review amount to serious professional misconduct, the PRC may decide to make a complaint against the practising member(s) which may ultimately result in disciplinary action. In 2019, three first time reviews of other practices resulted in complaints being raised by the PRC. One of these reviews identified significant deficiencies in its audit methodology and monitoring review function that are two of the Top 5 findings. All these reviews identified matters that showed issues about the professional conduct and integrity of the practices (e.g. having issued a compliance report without carrying out any work or provided false information / representation to practice reviewers). Moreover, six complaints were raised by the PRC against the practitioners of practices for matters identified in reviews that were not first time. The results of reviews suggest that these practices failed to improve their audit quality and were unable to comply with directions of the PRC to rectify the deficiencies identified in the first time reviews.

In addition, four cases resulted in complaints due to non-compliance with the PRC’s direction to deal with the dispute arising from the inability to conduct a practice review.

For complaints based on unsatisfactory practice review results, recently completed disciplinary cases show that disciplinary committees are prepared to cancel a member’s practising certificate for up to two years. For complaints against uncooperative practices, there has been one case where the disciplinary committee ordered the practising certificate of the relevant respondent be cancelled and her name be removed from the CPA register for three years. Practices should bear in mind the serious consequences that may result from a complaint being raised by the PRC.



Our work and review outcomes – Professional standards monitoring programme

The programme is a non-statutory financial statements review programme set up in 1988 with the objective to enhance the quality of financial reporting and the application of professional standards in Hong Kong. It is regarded as a useful programme to help understanding of professional standards and assess post-implementation issues.



If there are any matters found in the reviews that indicate possible non-compliance with professional standards, enquiry letters will be issued to members (primarily auditors of the listed companies) requesting explanations of the issues identified. Matters raised primarily focus on financial reporting but the QAD also looks into audit if significant issues are identified. The QAD determines if follow up actions are required on the issues raised with the auditors based on the reviews of the auditors' replies to our enquiry letters. Follow up actions include issuing further enquiry letters and letters with comments to advise members of areas for future improvement. If the issues identified indicate significant potential non-compliance with professional standards that constitutes a "Relevant Irregularity" or "Relevant Non-compliance" as defined under the Financial Reporting Council Ordinance, the financial statements, and our concerns, will be referred to the FRC for investigation.

Changes are often made to subsequent financial statements in light of our comment letters. In order to ensure that members benefit from our programme so as to enhance the quality of financial reporting in Hong Kong, the QAD communicates significant or common weaknesses identified from the reviews to members through different channels including the QAD annual reports.

The programme is supported by the Professional Standards Monitoring Expert Panel ("Expert Panel") and independent external reviewers ("Independent Reviewers"). The Expert Panel is an advisory panel that gives advice to the QAD on the appropriate course of action on significant, complex or controversial issues. The Expert Panel in 2019 comprised representatives from the Big Four firms, medium-sized practising firms and Hong Kong Exchanges and Clearing Limited ("HKEX"). Please refer to Annex for composition of the Expert Panel.

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

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

Our work

The review process comprises three stages:

Stage 1 – Initial review

- Published financial statements initially reviewed by the QAD and Independent Reviewers

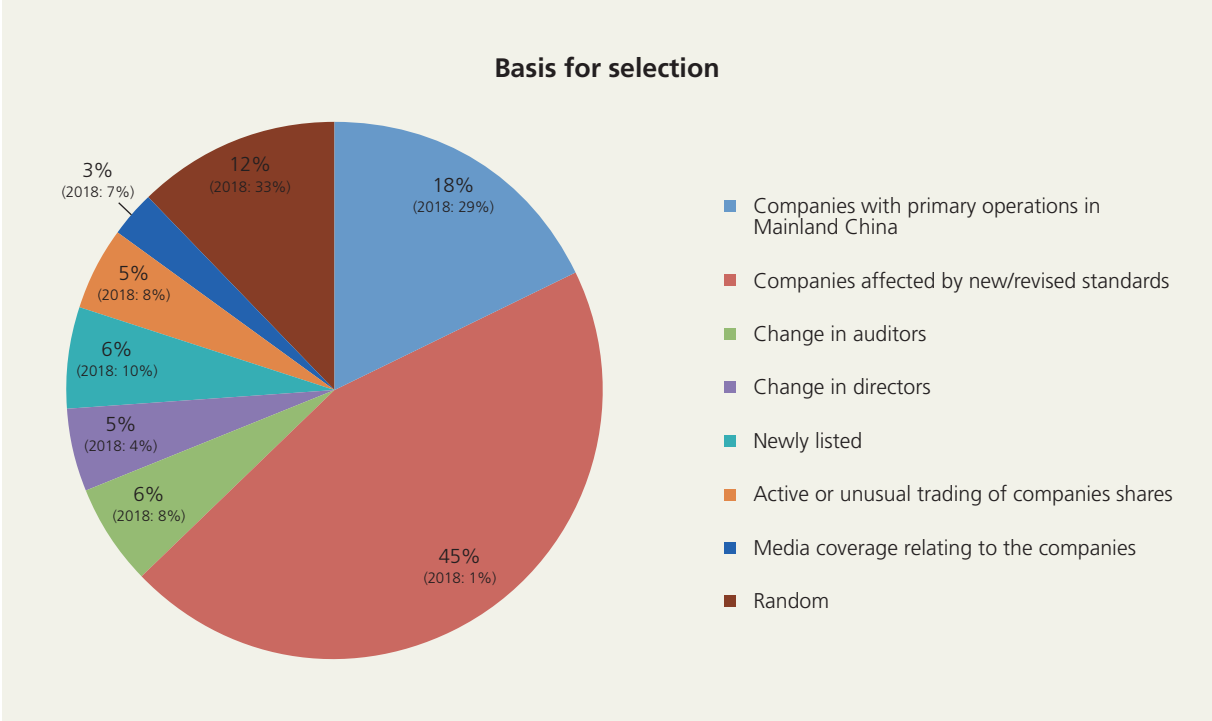
Stage 2 – QAD review

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

Stage 3 – Follow up

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

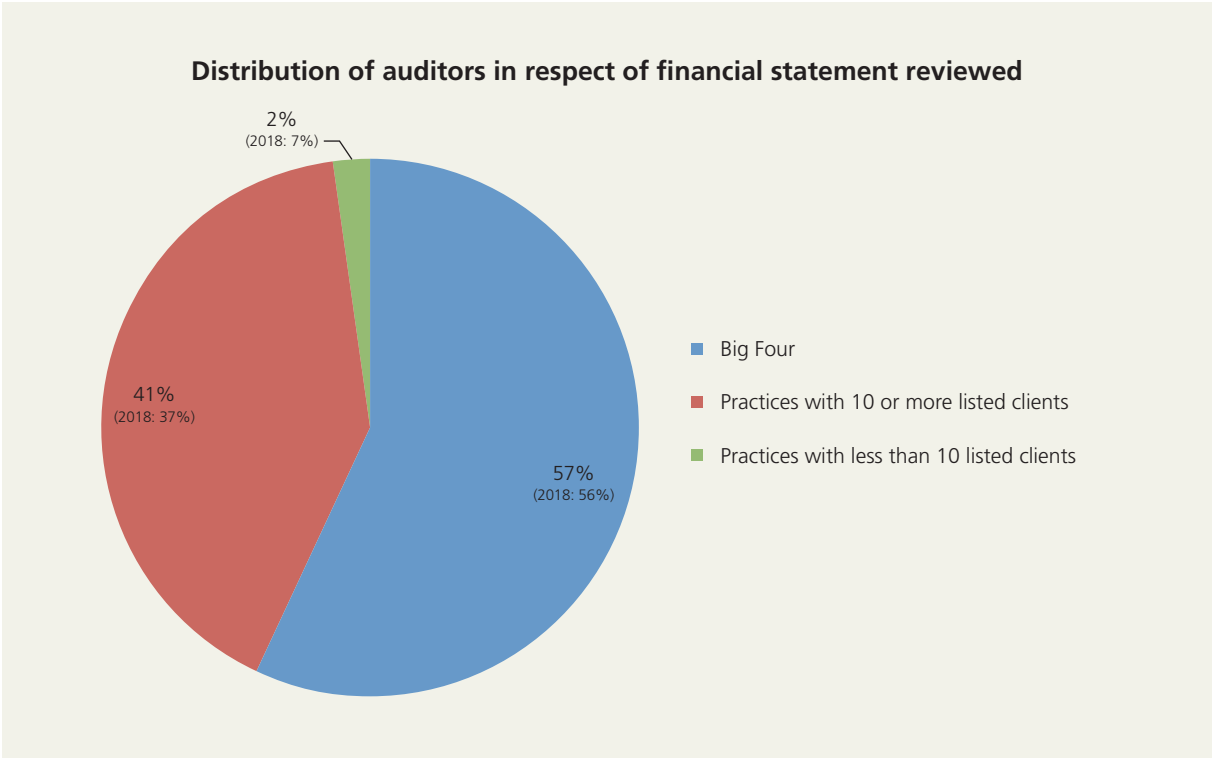
The programme uses a risk-based approach to select financial statements for review. The following chart shows the basis of selection of financial statements reviewed in 2019.



The category “Companies with primary operations in Mainland China” included some financial statements which were prepared under China Accounting Standards for Business Enterprises.

Review of initial application of new financial reporting standards is a focus of our programme. In 2019 reviews, application of HKFRS 9 (2014) *Financial Instruments* and HKFRS 15 *Revenue from Contracts with Customers* was our focus of review. Please see “Our findings – Professional standards monitoring programme” for the issues identified from the initial application of these two standards.

The following chart shows the distribution of auditors of the financial statements reviewed in 2019:



Our review outcomes

In 2019, the QAD reviewed a total of 65 sets of financial statements and followed up 6 cases brought forward from the previous year. Although follow up action was not needed for the majority of financial statements reviewed in 2019, issues were identified in some financial statements which warranted issuance of enquiry letters or letters with comments on presentation and disclosures. Please refer to “Our findings – Professional standards monitoring programme” for more information of those issues.

Referrals are made to the FRC for investigation when the QAD identifies potential significant non-compliance with professional standards. No cases were referred to the FRC in 2019.

Our findings

Practice review programme

This is the thirteenth annual report on our practice review programme. In 2019, we carried out 247 onsite and 107 desktop reviews, including 13 follow up visits. The results of the 2019 practice reviews show that the majority of practices met overall standards for audit quality and complied with professional standards. In 2019, approximately 65% of practices achieved this standard such that their practice reviews were directly closed without the need to follow up, an increase from 61% in 2018. While the results have shown an improvement from last year, practices still have more to do to ensure the current closing rate is not only sustainable but can be further improved.

In order to help practices to further improve, we continue to highlight key findings identified from practice reviews and provide guidance to practitioners on remedial actions. Key findings and suggestions for improvement are shown below in three parts:

- Part I: Quality control
- Part II: Engagement performance
- Part III: AML Guidelines compliance

In Part I, we cover common **quality control** issues on areas that have an impact on audit quality, including (1) monitoring review, (2) engagement quality control review, (3) auditor's independence, (4) file assembly, and (5) integrity and professional conduct. In Part II, we draw members' particular attention to key findings on **engagement performance**, including those concerning: (1) audit methodology, (2) audit evidence and documentation, (3) business combinations, impairment assessments and fair value measurements, and (4) audit reporting. In Part III, we highlight the findings from our reviews of the practices' level of **compliance with the AML Guidelines**. Discussions about a root cause analysis and our expectation are included at the end of this section.

We also encourage practices to take note of other key findings published in past annual reports available at the Institute's website.

Part I: Quality control

An effective system of quality control provides a strong foundation to achieve consistent engagement quality. The findings from practice reviews reveal that the application of several aspects of HKSQC 1 by practices can be enhanced.

The table below shows five common areas where further improvement is required to meet the relevant professional standards.

Description	Professional standard(s)
Monitoring review	HKSQC 1 and HKSA 220
Engagement quality control review	HKSQC 1
Auditor's independence	HKSQC 1 and Code of Ethics
File assembly	HKSQC 1 and HKSA 230
Integrity and professional conduct	Code of Ethics

1) *Monitoring review*

Monitoring is a process comprising an ongoing evaluation of a practice's system of quality control (i.e. an ongoing policy review) and a periodic inspection of a selection of completed engagements (i.e. a completed file review). Monitoring is essential to measure the operational effectiveness of the quality control system. Reviews undertaken by regulators (such as practice reviews) are not a substitute for a practice's own internal monitoring program. HKSQC 1 requires a practice to entrust a partner or another person with sufficient and appropriate experience and authority to assume the responsibility for the monitoring process.

Examples of issues identified from our reviews are:

- An ongoing policy review was not performed annually as required by HKSQC 1.
- An ongoing policy review included only an update of the quality control manual but not a compliance review of quality control policies and procedures.
- Engagements selected for inspection did not cover at least one completed engagement for each engagement partner at least once every three years.
- The engagement selection did not take into consideration factors set out in HKSQC 1.A66, such as the nature and complexity of the practice, and the risks associated with the practice's clients and engagements. For instance, only one simple engagement was selected for a completed file review without giving consideration to selecting a higher risk or a more representative engagement in the portfolio.

- The monitor did not identify deficiencies in the practice’s quality control system and engagements that were subsequently found in the practice review, which indicated the review was not effective.
- No follow up actions had been taken to address the comments and recommendations given by the monitor.
- No consideration was given to the competence and independence of the monitor.

Practices are reminded that the results of a monitoring review should be reported to their management at least on an annual basis. A monitoring report should include a description of the procedures performed and the conclusions reached. Practices should take remedial actions to address the deficiencies identified by a monitoring review including one or more of the following:

- consider the root causes of the deficiencies;
- change or enhance relevant quality control policies and procedures;
- communicate the findings to all partners and staff; and
- if necessary, take disciplinary actions against those who failed to comply with relevant policies and procedures and professional standards.

2) Engagement quality control (“EQC”) review

An EQC review is not the same as a monitoring review. As indicated above, monitoring is an element of HKSQC 1. An EQC review on the other hand is performed before an auditor’s report is issued and is required for all audits of financial statements of listed entities and other engagements meeting the additional criteria as determined by practices e.g. public interest entities. An EQC review should be performed by a partner or an individual having similar technical competence and authority who is not part of the audit team.

Our reviews identified the following weaknesses in EQC reviews that affected the overall quality of the audits performed:

- No or insufficient documentation to demonstrate that the EQC reviewer had reviewed audit work papers on areas involving significant audit judgements, including determination of materiality and significant audit risks.
- The EQC reviewer did not identify nor sufficiently challenge the appropriateness and sufficiency of the work performed by the audit team on key audit areas e.g. impairment assessment of a cash-generating unit, and accounting for financial instruments.
- The EQC reviewer was not involved in a timely manner e.g. no involvement at audit planning and in discussions of significant audit matters at appropriate stages of the audit.

- The EQC reviewer failed to identify significant non-compliance with professional standards in the areas reviewed.
- No evidence to show that an EQC reviewer had sufficient and appropriate technical expertise, experience and authority to adequately carry out the review.

The above weaknesses raised doubts about the effectiveness of the EQC reviews. Practices are reminded that an EQC review is an important part of the audit process. It is designed to help ensure the audit team has obtained appropriate audit evidence on key risk areas. Practices should establish the nature, timing and extent of an EQC review, criteria for eligibility of an EQC reviewer and documentation requirements. An EQC review ordinarily involves discussions of significant matters with the engagement partner, a review of the financial statements, the auditor's report (including the key audit matters included therein) and the reports to those charged with governance, and consideration of whether the auditor's opinion is appropriate. It also involves a review of selected working papers relating to the significant judgements the audit team has made and the conclusions they have reached.

HKSQC 1 requires an EQC review to be conducted on a timely basis so that significant matters are resolved prior to the audit opinion being issued. Practices are expected to involve the EQC reviewer at audit planning and reporting stage, and retain evidence that the EQC reviewer has been consulted on audit risks, judgement areas, and significant accounts. Practices should ensure that their EQC reviewers have sufficient technical expertise and are able to carry out objective reviews over the assignments. Where significant non-compliance is identified in a listed engagement reviewed in a practice review, consideration will be given to raising a complaint against both the engagement partner and the EQC reviewer as they are both responsible for ensuring a high quality audit be carried out to support the appropriateness of the audit opinion issued.

3) Auditor's independence

Practices should be mindful that their audit clients place a high value on the quality and independence of their work. An effective identification and assessment of threats to independence, an application of appropriate safeguards, and proper reporting of related matters to audit committees or client management, are critical parts of an audit.

The following are examples identified from practice reviews that showed how practices did not comply with the independence requirements:

- Practices failed to assess the significance of self-interest or intimidation threats created and/or apply safeguards to address threats arising from undue fee dependence on an audit client. Examples of safeguards suggested under Section 410.3 A6 of the Code of Ethics include: (a) increasing the client base of the partner or the practice to reduce dependence on the audit client; or (b) having an independent quality engagement reviewer.
- No safeguard was applied to resolve the conflict of interest arising from situations where an audit client entity was in substance managed by the practitioner.

- Failure to identify and address the self-review threats when non-assurance services (e.g. book keeping) and audit work were performed for the same client.
- The serving period of a practitioner as a key audit partner for a listed client exceeded the limit of seven years allowed under the Code of Ethics.

Practices are reminded that non-compliance with the auditor's independence requirements is a breach of the Code of Ethics. All services provided to each client should be identified and evaluated to ensure that the auditor's independence is not impaired. In cases where the practices' independence is threatened, a safeguard should be put in place or the practices should resign as auditors.

Practices should also pay attention to the recent changes in the partner rotation requirements for audits of public interest entities, including an increase from a two to a five-year cooling-off period for engagement partners, and a prohibition on the audit team from consulting with a former engagement partner (or an EQC reviewer) on a technical or industry-specific issue during the cooling-off period.

4) File assembly

Practices should establish policies and procedures to ensure audit teams complete the assembly of audit files on a timely basis, which should not normally be later than 60 days after the date of the auditor's report. The date of final assembly should be clearly recorded on the audit file after file assembly has been completed.

Our reviews identified instances showing non-compliance with the file assembly rule, including:

- Not retaining all audit work papers or supporting documents in the assembled audit files.
- Not including the final version of audit work papers in the assembled audit files.
- Failing to archive and assemble audit files as required by the practices' file assembly policy.
- No adequate control over timely assembly of audit files (either in electronic or paper file format).
- Not evidencing the assembly of audit files to demonstrate the completion of assembly within 60 days of the date of the auditor's report.
- Modifying existing work papers after the file assembly date without providing documented reasons and trails.

Practices are reminded that file assembly is an administrative process that does not involve the performance of new audit procedures or the drawing of new conclusions. In exceptional circumstances where a practice finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, additional information is required to be documented on file, as per requirements of HKSA 230, including the specific reasons for making the changes and when and by whom they were made and reviewed.

5) Integrity and professional conduct

Integrity is one of the core values under the Code of Ethics. Practices have a duty to adhere to high standards of professional behavior in the course of their work and in their relationships with their audit clients. Instances identified from practice review that cast doubt on the integrity and the conduct of practices and audit teams cause great concerns as those matters are fundamental to the audit profession. Examples are as follows:

- Provision of an incomplete client list or deliberately hiding engagements from the client list prepared for practice review purposes.
- Fabrication or improper modification of working papers and documentation to the final audit files before the practice review commenced.
- Provision of false information in the practice review process including the electronic self-assessment questionnaire (“EQS”) in an attempt to manipulate the chance of being selected for a practice review or to disturb the practice review outcomes.

In our practice review programme, the Practice Review Committee has decided to raise complaints against a number of practitioners because of the above matters.

Practices are reminded to (a) ensure sufficient appropriate audit evidence has been obtained before the audit report is issued; (b) exercise due care in completing an EQS; and (c) check completeness of the client list before submission to the practice review team. Practices should be aware that we have standard procedures in place to check the completeness of the client list provided and, if we encounter instances that suggest that additional working papers have been created for the pre-selected engagements, we will extend our review scope to spot check additional audit engagements.

6) Other quality control issues

Our reviews also identified other common quality control issues, such as the following:

- The engagement partner and manager did not perform an effective file review process on engagements, including those that involved work performed by a subcontractor.
- Practices did not establish formal consultation or technical review policies and procedures, nor maintain documentary evidence to show that a technical review or consultation had taken place.
- Practitioners did not undertake sufficient technical learning to gain appropriate knowledge of current professional standards and relevant legal requirements.
- Practices did not provide appropriate training to their audit staff to ensure they are competent enough to appropriately handle audit engagements, particularly regulated or specialized industry engagements.

- Practices did not exercise sufficient due care in the acceptance and continuance process to critically assess whether they had the competence, capability, time or resources to properly perform the audit work before taking on the engagement, particularly compliance reporting engagements.

Practices might recognize that some of the above shortcomings exist in their quality control systems. Practices are advised to take appropriate actions to address the shortcomings before they are found in a practice review.

Part II: Engagement performance

Practices should take steps to ensure that engagements are performed in accordance with professional standards and guidance. Practices often use an audit manual to guide their audit staff to follow their audit methodology. Ensuring good engagement performance requires proper direction, supervision and review.

1) Audit methodology

Current auditing standards lay the foundation for the development of practices' audit methodology. In our reviews, we continued to find that some practices' audit methodology did not adequately address requirements of auditing standards. Common shortcomings in audit methodology included:

Audit areas	Findings
Journal entry testing	<ul style="list-style-type: none"> No completeness test performed in journal entry testing. No selection of journal entries with fraudulent risk characteristics for journal entry testing.
Consideration of fraud risk factors	<ul style="list-style-type: none"> No consideration given to conditions that might contribute to fraud risk factors, i.e. incentives, opportunities and rationalizations, in risk assessment. No assessment of the possible presence of the additional fraud risk factors (e.g. existence of hold mail arrangements, operation of discretionary accounts, issuance and acceptance of third party or cash cheques) set out in PN 820 paragraph 30 in audits of regulated entities.
Audit risk assessment	<ul style="list-style-type: none"> No assessment of audit risk areas at the assertion level (e.g. valuation of inventories, and recoverability of receivables). No linkage of the results of the preliminary analytical procedures to the audit risk assessment at audit planning.
Internal control evaluation	<ul style="list-style-type: none"> No documentation of an understanding of the internal controls over the client's major business processes other than bank reconciliations, and no evaluation of design and implementation of key controls.

Materiality	<ul style="list-style-type: none"> • No justification for the benchmark used to determine overall materiality. • No consideration of whether further testing was necessary even though the final materiality level was lower than the planning materiality level. • Setting a different materiality level for balance sheet and income statement instead of an overall materiality level for the financial statements as a whole.
Audit testing and sampling	<ul style="list-style-type: none"> • Applied an incorrect inherent risk factor or performance materiality in calculating the sample size for tests of details, resulting in fewer items being tested than should have been required. • No consideration of population value, materiality, and assessed audit risks in sample size determination.
Evaluation of misstatements	<ul style="list-style-type: none"> • No evaluation of the effect of the uncorrected misstatements on the financial statements, and no evidence to show that those misstatements had been communicated to the client management.
Audit confirmations	<ul style="list-style-type: none"> • Arranged audit confirmations through the clients. Practices should exercise adequate controls over the external confirmation procedures and send out requests and receive audit confirmations directly.
Audit of opening balances	<ul style="list-style-type: none"> • Other than obtaining the prior year audited accounts and checking the opening balances to the general ledger, no other audit work performed such as sending audit confirmation requests to confirm material opening balances.
Subsequent event review	<ul style="list-style-type: none"> • Subsequent event review procedures were limited to an enquiry with management about subsequent events without carrying out other required audit procedures, such as reviewing subsequent minutes and management accounts.
Going concern assessment	<ul style="list-style-type: none"> • No audit work performed to assess the financial capabilities of the client's shareholders who undertook to provide adequate financial support to the client.
Internal control deficiencies	<ul style="list-style-type: none"> • No evidence that audit teams had assessed the audit implications arising from internal control deficiencies e.g. whether evidence of compensating controls or actions was available for checking during the audit.

Practices are reminded that they should undertake regular reviews and updates of their audit methodology to ensure it reflects latest changes in auditing standards. Practices should also provide sufficient training to ensure their audit staff members apply their methodology correctly and consistently.

2) Audit evidence and documentation

Practices should obtain sufficient and reliable audit evidence to enable them to draw reasonable conclusions on which to base the audit opinion. Audit documentation should provide a sufficient and appropriate record of the basis for the auditor’s report and evidence that the audit has been performed in accordance with professional standards. Without adequate documentation, it is hard to prove that the auditor had carried out sufficient appropriate work to support the audit opinion or conclusion given.

The following sets out some common audit areas on which evidence and documentation deficiencies were found from our reviews:

<ul style="list-style-type: none"> • Initial application of HKFRS 9 and HKFRS 15
<ul style="list-style-type: none"> • Related party transactions and balances
<ul style="list-style-type: none"> • Group audits
<ul style="list-style-type: none"> • Construction contracts
<ul style="list-style-type: none"> • Point-of-sale systems
<ul style="list-style-type: none"> • Onerous contracts

2.1 Initial application of HKFRS 9 and HKFRS 15

Two major new HKFRSs, HKFRS 9 *Financial Instruments* and HKFRS 15 *Revenue from Contracts with Customers*, became effective for annual periods beginning on or after 1 January 2018. More common issues identified during our reviews include:

- No documentation of the consideration given to reclassification of equity and debt investments under HKFRS 9.
- No documentation of the audit procedures performed to assess the reasonableness of the internal credit rating determined by the client for each category of trade debtors used in the assessment of the adequacy of the expected credit loss allowance on accounts receivable under HKFRS 9.
- No evidence to show that forward looking factors had been taken into account in the determination of the debtor default rates as required by HKFRS 9
- No documentation of the audit team’s assessment of the impact arising from adoption of HKFRS 15 on bundle sales contracts.

2.2 Related party transactions and balances

Related party transactions and balances are often an important audit area to which practices should pay particular attention during the course of an audit. Companies controlled by the directors, associated companies, joint ventures, the key management personnel, and major shareholders are examples of related parties under HKAS 24 *Related Party Disclosures*. HKSA 550 establishes standards and provides guidance on the auditor's responsibilities and audit procedures regarding related party transactions and balances.

Deficiencies identified in audit work on related party transactions and balances included:

- No work performed to assess the expected credit loss on material related party receivables.
- Insufficient evidence available to support the classification and presentation of loans from/to related parties as current or non-current assets or liabilities.
- No evidence to show that an understanding was obtained of the client's internal controls over the completeness of related party transactions.
- No audit work performed to verify the client relationship with related parties.
- Reliance placed on information provided by the clients without performing procedures to identify undisclosed related parties and related party transactions and balances.
- No work performed to validate the significant movements during the year in the related party balances.
- No audit work performed to ascertain the occurrence of related party transactions e.g. sales, purchases and consultancy fees.

2.3 Group audits

Audits of groups of entities that operate under different regulatory and economic environment have always been challenging. HKSA 600 establishes the relative responsibilities of the group auditor and the component auditors and how the relationship between them should be managed.

Common issues identified during our reviews include:

- Audit teams did not evaluate which subsidiaries were significant to the group in order to determine the appropriate scope of work on each subsidiary.
- Audit teams neither determined component materiality nor assessed whether the materiality levels reported and used by component auditors were appropriate.
- Insufficient communication with component auditors, e.g. no communication of the matters relating to the significant risks of material misstatements identified by group auditors.

- No evidence to show that audit teams had adequate involvement in component auditors' risk assessments and ensured that all significant risk areas identified related to components had been properly addressed by component auditors.
- No audit trail provided to follow through the work done to address discrepancies between the draft financial statements and the audited financial statements of components and to support the subsequent work done on file.
- No documentation to show how audit teams were satisfied that sufficient audit evidence had been obtained by component auditors to address the identified audit risks in material account items e.g. inventories and account receivables.

2.4 Construction contracts

As in prior years, audits of construction contracts remains a common concern. We continued to find cases where evidence gained to support related revenue recognition was insufficient and/or inappropriate. For example:

- In one case, the client was primarily engaged in provision of engineering services, which met the definition of construction contracts in Section 8 of SME-FRS. The client recognized (a) contract revenue only when services had been completed and (b) contract costs only when invoices were received, instead of according to the stage of completion of the contracts in accordance with Section 8 of SME-FRS. However, the auditor did not assess the appropriateness of the client's accounting treatment; and
- In another case, there was no evidence to show that the audit team had (a) checked the accuracy of total estimated contract costs and assessed whether contract costs incurred for specific contracts were correctly allocated; (b) obtained management explanation for the projects with significant variation orders or significant changes in budgeted costs; and (c) assessed whether there were any possible expected losses on contracts required to be immediately recognized as expenses.

2.5 Point-of-sale ("POS") systems

A POS system is commonly used by a retail business to record sales. It is important to ensure completeness and accuracy of sales recognition and therefore adequate audit work is expected to be carried out to cover the POS system of the client. However, the following deficiencies were commonly identified:

- No adequate understanding of the POS system and internal controls relevant to financial reporting (e.g. general computer controls, application controls and controls over data transfers from POS system to accounting system), and no evaluation of design and implementation of those internal controls.
- No testing of the POS system-generated documents e.g. sales memos and revenue reports for completeness and accuracy before using them for tests of details.

2.6 Onerous contracts

Onerous contracts are contracts in which the unavoidable costs of meeting the obligations under the contracts exceed the economic benefits expected to be received under them. When an event takes place that makes a contract onerous, a provision should be recognized. A common example of such an event is a termination of a lease before the lease contract expires. In practice reviews, we identified cases where the client circumstances suggested onerous contracts might exist but no consideration was given to whether a provision for onerous contracts should be recognized. The following is a common example:

- Some shops operated by the client were loss making and there had been plans to close down those shops. There was however no assessment of the provision required to be recognized for onerous contracts arising from non-cancellable tenancy agreements.

Practices are also reminded that, before a separate provision for an onerous contract is established, there is a need to assess whether any impairment loss should be recognized on assets dedicated to that contract.

3) *Business combinations, impairment assessments and fair value measurements*

3.1 Business combinations

HKFRS 3 (revised) *Business Combinations* requires consideration be given to the existence and measurement of goodwill and separable identifiable intangible assets that have been acquired as part of each business combination. The valuation of these items would very often be dependent on cash flow forecasts that involve estimation of future business growth and application of a discount rate, which are inherently subjective.

During our reviews, we found cases which showed that insufficient evidence was obtained to support the accounting for acquisitions. The key findings identified in this area are summarised as follows:

- Insufficient audit work performed on business acquisitions that gave rise to significant goodwill e.g. (a) no review of relevant agreements related to the acquisitions; and (b) no understanding of the underlying factors that made up the significant goodwill; and (c) no checking to confirm whether the vendors in the acquisitions were related parties.
- No evidence of work performed to assess whether profit guarantees provided by vendors according to acquisition agreements were contingent consideration arrangements; and if so, whether their acquisition date fair value measurement was appropriate.
- No assessment as to whether there were any identifiable intangible assets that should have been separately recognized at the acquisition date.
- No audit work performed to ascertain that fair values of non-cash purchase consideration, such as convertible notes, established were appropriate.

Practices are reminded to pay particular attention to the following procedures that are often important in assessment of the appropriateness of the accounting for and disclosure of business combinations:

- evaluate the design and implementation of internal controls relating to accounting for the business combinations;
- obtain the cash flow forecasts used to support the valuation of intangible assets identified and assess whether these are reasonable;
- evaluate the reasonableness of methodology and key assumptions used to value intangible and other assets;
- assess or re-compute the deferred tax liabilities on acquired intangible assets and verify if appropriate tax rates have been considered; and
- check the adequacy of disclosures in the financial statements.

3.2 Impairment assessments of cash-generating units (“CGU”)

The CGU impairment assessment often requires reviews of future cash flows, which involve significant judgement and can be prone to management bias. Practices should corroborate and challenge the assumptions and data used to support the impairment assessment conclusions.

In reviewing audit work on CGU impairment assessment, we sometimes found that there was insufficient consideration and challenge of management’s cash flow forecasts used in the impairment assessment and failure to identify non-compliance with HKAS 36 *Impairment of Assets*. Related issues identified during our reviews include:

Value in use

- No evidence that audit teams had challenged the reasonableness of key assumptions, e.g. growth rate of revenue and expenses, changes in net working capital, and market information on comparable companies used by valuers.
- No evidence obtained to substantiate that the capital expenditures included in the cash flow forecasts were not intended to be spent on improving or enhancing the assets’ performance as HKAS 36 specifically disallows capital expenditures used for those purposes to be included in the forecasts.
- No evidence that audit teams had sufficiently challenged why a period longer than five years was used to develop the base projection for the cash flow forecast.
- No assessment of the key parameters used to calculate the discount rate (e.g. the risk-free rate, the market risk premium, and the beta data).
- Using a post-tax discount rate to discount pre-tax future cash flows. HKAS 36 requires the use of pre-tax cash flows and pre-tax discount rate in the impairment assessment.

Fair value less costs of disposal

- Failure to identify whether the recoverable amount of a CGU was determined based on its fair value less costs of disposal or its value in use. It is important to note that the fair value less costs to sell should be determined on a basis consistent with the assumptions used by market participants rather than those used by management in estimating the value in use.

CGU carrying amount

- No identification of incorrect allocation of assets and liabilities to a CGU. For example the CGU carrying amount inappropriately included bank balances and cash, and tax liabilities, which are not allowed under HKAS 36. Under HKAS 36, assets are allocated to a CGU if either they can be directly attributed to the CGU, or they can be allocated to the CGU on a reasonable and consistent basis. Liabilities are only included in the carrying amount of a CGU when the recoverable amount of a CGU cannot be determined without consideration of the liability.
- Failure to notice that the carrying amount of goodwill allocated to the CGU was not grossed up to include the goodwill attributable to the non-controlling interest of the non-wholly owned subsidiary.

Practices are reminded to pay attention to the following audit procedures that are important for testing of goodwill impairment:

- evaluate the client's identification of CGUs, the carrying value of each CGU and the methodology used by the client for impairment assessment to ensure compliance with HKAS 36;
- assess the appropriateness of key assumptions used in development of the cash flow forecasts, such as growth rates, profit margins, discount rates, with specific reference to client business and historical trends; and
- check the adequacy of disclosure in the financial statements.

3.3 Fair value measurements

Fair values are sometimes developed based on complex management models which require a large number of assumptions and other inputs, particularly when they are done on complicated financial instruments or specialised assets. Practices should carefully assess the risks inherent in different measurement approaches, and design and perform audit procedures responsive to those risks.

In our practice reviews, we identified the following shortcomings in the audit work done to test the fair values of assets:

- No audit work performed to investigate the significant variances between the valuation assumptions (e.g. yield rates and market rents used in the income capitalisation approach and market price per square meter/foot used in the direct comparison approach) stated in the property valuation reports and those estimated by audit teams based on market information of comparable assets.

- Failure to appropriately evaluate the work of valuers (such as the key input data used and the valuation methodology) before relying on the valuation reports (e.g. on biological assets).
- No evidence of work performed to assess how indicators of economic (e.g. downturn in the manufacturing of products) or physical obsolescence (e.g. physical deterioration or wear and tear) could impact on the fair value of plant and machinery used in the impairment assessment.

An appropriate level of professional skepticism is essential for auditing significant judgement areas in fair value measurements. Practices are reminded to appropriately assess management's key assumptions and compare them to available independent audit evidence. They should also, where appropriate, critically challenge management assumptions in relation to profit forecasts, increases in market share, cash flow projections and discount rates. Involvement of experienced senior staff is important to ensure the audit risks associated with fair value measurements are addressed in an effective and efficient manner.

4) Audit reporting

Auditors express an unqualified opinion on financial statements when they conclude that the financial statements are free from material misstatements. HKSA 700 establishes requirements regarding the form and content of the auditor's report and HKSA 705 (Revised) sets out guidance on how the audit opinion should be modified if an audit qualification is needed. In some circumstances, auditors shall, without modifying the audit opinion, include an emphasis of matter paragraph in the auditor's report according to HKSA 706 to draw users' attention to specific significant matters.

For audits of listed entities, auditors are required to report key audit matters ("KAM") which require significant auditor attention in their auditor's report under HKSA 701. KAMs are selected from matters communicated with those charged with governance. In making their determination of what is shown as KAM, auditors shall take into account the following: (a) significant risks or financial statement level risks identified; (b) significant auditor judgements relating to areas in the financial statements that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty; and (c) the effect on the audit of significant events or transactions that occurred during the period.

Issues identified during our reviews concerning audit reporting include:

For audits of listed entities

- KAMs were described in general terms rather than being specific to the circumstances of the client entity;
- The audit procedures for the KAM were not clearly described;
- The work performed by the auditor was not consistent with the description of the work procedures for the KAM in the auditor's report;
- There was no documentation of the rationale for the audit teams' determination of KAM.

For other auditor's reporting

- Practices did not assess whether the effect of the scope limitation imposed by the client or disagreement about the client's accounting treatment was material and pervasive nor justify why a qualified or an adverse opinion or a disclaimer of opinion was appropriate.
- Practices did not include in the basis for qualified opinion section the reasons for the inability to obtain sufficient appropriate audit evidence as required by HKSA 705 (Revised).
- No work performed to remove the need to repeat the previous year's qualification or to qualify comparative figures in the auditor's report.
- The auditor's report did not include a separate section to highlight a material uncertainty relating to going concern of the client.
- No qualification in the auditor's report in respect of non-compliance with the Companies Ordinance although the financial period covered by the client's financial statements was longer than 18 months.
- The auditor's report did not set out the name and practising certificate number of the engagement director responsible for the performance of the audit as required by the Institute's Corporate Practices (Registration) Rules.

For audits of listed entities, practices are reminded that, while KAM will not replace the importance of the auditor's opinion on the financial statements as a whole, they supplement the report by asking the auditor to describe what matters are significant, why they are significant, and how the audit addressed them. KAM should be clear and concise.

For other auditor's reporting, practices are reminded that if there is a scope limitation imposed by client management, they should generally not accept or re-accept that audit engagement. Practices are also reminded that a modified opinion should not be used to circumvent necessary audit procedures such as an inventory count.

Part III: AML Guidelines compliance

1) Issues relevant to all practices regardless of services provided

Determining scope of compliance

Some practices were not aware that their services involved work to prepare for or carry out Specified Transactions. Hence, the relevant requirements in the AML Guidelines, including CDD, ongoing monitoring and record keeping, which are mandatory for Specified Transactions, were not complied with. Examples of such engagements include a reporting accountant engagement in respect of a major transaction, very substantial acquisition or disposal transaction relating to buying and selling of business entities or real estate; or an appointment that gives a practice the power to manage a client's bank, saving or securities account.

Practices are reminded that when they consider whether to accept a client engagement, they should obtain sufficient information to fully understand the nature and purposes of the engagement. If an engagement involves work to prepare for or carry out a Specified Transaction, the practice has to comply with all the requirements set out in Sections 610 – 670 of the AML Guidelines.

Application of good practices

The extent to which a practice should comply with the requirements of the AML Guidelines depends on whether the practice had been or intends to be involved in work to prepare for or carry out Specified Transactions (referred to below as Specified Transaction work) for its clients. Requirements on making suspicious transaction reports (Section 640 of the AML Guidelines) and financial sanctions and terrorist financing (Section 650 of the AML Guidelines) are mandatory regardless of the services provided by practices.

Unless a practice provides Specified Transaction work, it is not mandatory to comply with other sections of the AML Guidelines (e.g. CDD, ongoing monitoring, record keeping, etc). The practice however may choose to comply with those non-mandatory sections as good practice.

In ACMRs, we found that many practices had adopted the example policy set out in the AML Procedures Manual for Accountants published by the Institute without appropriate tailoring. This had resulted in them having adopted all good practice procedures even though they had no intention to apply them as they had no Specified Transaction work.

Practices should ensure that their AML / CTF policies and procedures reflect their circumstances, including whether good practices are to be applied. If a practice chooses not to apply good practices, it should not state in its AML / CTF policies and procedures that CDD and ongoing monitoring procedures are applied on all clients (as opposed to stating that CDD and ongoing monitoring procedures are applied to only clients, whether new or existing clients, whose engagements involve Specified Transactions). Practices may make reference to the example AML / CTF policies and procedures for practices not applying good practices in the frequently asked questions (“FAQs”) in the AML compliance section of the Institute’s website. On the other hand, if a practice chooses to apply good practices, it should ensure that it has sufficient resources to address all relevant requirements in the AML Guidelines. In an ACMR, review work will be performed to assess how well a practice has applied its AML / CTF policies and procedures, including the good practice procedures if the practice has chosen to apply them.

Sanctions screening

Section 650 of the AML Guidelines (Financial sanctions and terrorist financing) is mandatory for all practices regardless of the services provided. There are several pieces of legislation in Hong Kong prohibiting persons from making available financial assets or financial resources to terrorists and individuals and entities sanctioned by the United Nations. The AML Guidelines state that practices must comply with their legal obligations in relation to targeted financial sanctions and the financing of terrorism and proliferation of weapons of mass destruction. Practices must establish financial sanctions and counter-terrorist financing policies and procedures and take measures to ensure compliance with the relevant laws and regulations. On-going name screening of the entire client base by practices is a key control for the prevention of terrorist financing and sanctions violations. The following issues relating to sanctions screening were identified from ACMRs:

- Some practices had not established policies and procedures for sanctions screening. Practices should perform a sanctions check of a client against all current sanctions lists prior to commencement of a client relationship. In addition, practices should also check any new terrorists and sanctions designations against their client base as soon as practicable whenever there is an update in the terrorists and sanctions lists. Practices should maintain evidence of sanctions screening performed (e.g. a print out or screen capture of search results).
- Some practices did not take steps to follow up on potential matches identified from a sanctions check or shown in on-going screening alerts provided by their service providers. When a search result or an alert indicates that a client may potentially be a sanctioned subject or a terrorist, the practice should analyze whether the information provided is a true hit (i.e. a result that conclusively verified that the client is a sanctioned subject or a terrorist) or a false positive (e.g. a result showing certain attributes of the client cannot match with those of the sanctioned subject or terrorist). Practices should always document their assessment and follow up work performed.

2) Issues relevant to practices that provide Specified Transaction work or have adopted “good practices”

Firm wide risk assessment

Some practices did not appropriately assess the money laundering / terrorist financing (“ML / TF”) risks that they face. Paragraph 610.2.1 of the AML Guidelines requires that practices must establish and implement adequate and appropriate AML / CTF controls, taking into accounts factors such as types of clients and their geographical locations; services or products offered by the practices; mode of delivery of the services or products; and size of the practices. To address this requirement, practices are expected to carry out a firm wide risk assessment to identify, assess and understand the ML / TF risks they are exposed to and implement appropriate actions to mitigate the risks identified.

High risk countries

Some practices did not maintain a list of high risk jurisdictions. Paragraph 620.12.22 of the AML Guidelines requires that practices should give particular attention to and exercise extra care in respect of client relationships with entities and persons from or in jurisdictions that do not apply, or insufficiently apply, the FATF Recommendations; and transactions and businesses connected with jurisdictions assessed as higher ML / TF risk. Practices should develop their own list of high risk jurisdictions which should at least include the following two sources of information:

- High risk (call for action) and other monitored jurisdictions identified by the FATF. These are jurisdictions with strategic AML / CTF deficiencies identified by the FATF in its two public documents, namely *High-Risk Jurisdictions subject to a Call for Action* and *Jurisdictions under Increased Monitoring*, that are issued three times a year; and
- Jurisdictions subject to financial sanctions imposed by the United Nations.

Practices should review and update their list of high risk jurisdictions on a regular basis and communicate the list to their staff promptly to ensure consistent treatment within their practices.

Pre-existing clients

A pre-existing client is a client with whom the business relationship was established before the AML Guidelines came into effect on 1 March 2018. Some practices neglected to perform or consider the need to perform CDD procedures on pre-existing clients before they were engaged in work to prepare for or carry out for them a Specified Transaction on and after 1 March 2018 even though no such procedures had previously been performed on those clients.

According to paragraph 620.3.2 of the AML Guidelines, practices must perform CDD measures on a pre-existing client when, among others, an unusual or suspicious transaction, by virtue of the amount or nature of the transaction, takes place with regard to the client, and a practice has inadequate information for the purpose of identifying and verifying the client's identity. A transaction relating to a purchase or a sale of real estate or a business entity might fall outside a client's normal course of business. A transaction that falls under the definition of a major transaction, very substantial disposal or very substantial acquisition under the listing rules, thereby requiring an accountants' report to be issued, might also be considered as unusual in the context of the business of the client.

Therefore, before engaging in any engagement that involves a Specified Transaction for a pre-existing client, practices should give consideration as to whether the circumstances set out in paragraph 620.3.2 of the AML Guidelines apply and if so, they must first carry out CDD procedures on the pre-existing clients. If the practices, after consideration, conclude that none of those circumstances applies, it should maintain appropriate documentation of its assessment to support the conclusion reached.

Customer Due Diligence

According to paragraph 620.2.1 of the AML Guidelines, CDD information is an important element to determine whether there are grounds for knowledge or suspicion of ML / TF. It is intended to enable practices to form a reasonable belief that they know the true identity of each client and, with an appropriate degree of confidence, know the type of business and transactions that the client is likely to undertake and the source and intended use of funds. A standard level of CDD measures on a client includes identification of the client, its beneficial owner(s) ("BO") and the person(s) purporting to act on behalf of the client ("PPTA"); verification of their identities and PPTA's authority to act; and obtaining information on the purpose and intended nature of the business relationship. In high risk situations, an enhanced level of CDD ("EDD") measures shall be performed. EDD measures include, in addition to those performed for a standard CDD, obtaining approval from senior management of the Practice before commencing or continuing the client relationship; taking reasonable measures to establish the sources of wealth and funds of the client or its BO; and applying enhanced ongoing monitoring.

The following are related issues identified from ACMRs:

- Some practices did not perform a name check to identify whether their clients and BOs were a politically exposed person (“PEP”). If a client or its BO is a PEP as defined in the Anti-money Laundering and Counter-terrorist Financing Ordinance (“AMLO”) (i.e. a foreign PEP as defined in the AML Guidelines), EDD must be performed. If a client or its BO is a domestic PEP as defined in the AML Guidelines, the practice will need to assess whether the individual poses a higher ML / TF risk and, if so, perform EDD procedures.
- Some practices did not perform a name check to identify whether there is any adverse news connected to clients and BOs. If a client and / or its BO is found to be connected to adverse news, the practice will need to assess whether such matters reported in the news have an impact on ML / TF risks of the client.
- Some practices did not identify who was the PPTA of their clients nor undertake any work to verify the PPTA’s identity and authority to act. A person who is authorized to act on behalf of a client to establish a business relationship with a practice (i.e. the person who has signed or will sign an engagement letter on behalf of the client) should always be treated as a PPTA for the purpose of applying paragraph 620.7.1 of the AML Guidelines. Practices are reminded that when they apply simplified CDD (“SDD”) measures on a client, they are still required to identify the PPTA of the client and verify its identity and authority to act.

Staff training and hiring

- As required by paragraph 670.1.3 of the AML Guidelines, practices must provide appropriate AML / CTF training to their staff and should have a clear and well-articulated policy for ensuring that relevant members of staff receive adequate AML / CTF training. Issues relating to staff training included failure to provide training to all staff, as well as new staff before commencement of work; failure to cover all essential topics (e.g. suspicious transaction reporting, restrictions relating to tipping off and CDD procedures); and not having appropriate measures to assess effectiveness of staff training.
- Paragraphs 610.3.8 and 670.1.1 of the AML Guidelines require practices to establish policies and procedures to ensure the integrity of new employees. Some practices had not put in place such policies and procedures (e.g. performance of a name screening on a new employee) to address these requirements.

The Institute has developed and will continue to develop answers to FAQs regarding AML / CTF compliance which are posted on the Institute’s website. The FAQs also provide practical resources that assist practices in complying with the requirements of the AML Guidelines, including an example policy for practices that do not adopt good practices and links to online resources for sanctions checks. The FAQs can be found at: <https://www.hkicpa.org.hk/en/Tools/FAQ/Quality-assurance/Practice-review---AML-Monitoring>.

Root cause analysis

Identifying and addressing the underlying or root causes are considered to be an effective way to reduce the likelihood of future recurrence of similar deficiencies. Some common root causes identified are as follows:

- Resources issues, such as competencies and experience of audit staff, time pressure, and shortage of staff resources.
- Personal, ethical and attitude issues, such as unwillingness to acknowledge or learn from mistakes, and inability to direct, supervise or review effectively.
- Leadership and process issues, such as poor project management, quality control policies and procedures not properly complied with, and failure to consult when appropriate.

Practices need to consider whether issues identified are isolated issues or systematic issues that might be required to be addressed at a higher or holistic level. Any remedial actions developed, for example training and updating audit aids, need to be monitored and supported by senior management.

Expectation

The auditing environment has been evolving to adopt and accept greater use of technology in performing engagements and quality control activities. Despite all the changes, the need for good quality audits remains. In February 2019, the International Auditing and Assurance Standards Board (“IAASB”) released three exposure drafts that propose significant changes to the way practices manage quality. They are: (a) ISQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements or Other Assurance or Related Services Engagements* (previously ISQC 1), (b) ISQM 2 *Engagement Quality Reviews*, and (c) ISA 220 (Revised) *Quality Management for an Audit of Financial Statements*.

The proposed standards include a new proactive risk-based approach to effective quality management systems within firms that establish the foundation for consistent engagement quality. The IAASB proposals are intended to improve engagement quality through:

- modernizing the standards for an evolving and increasingly complex environment, including addressing the impact of technology, networks, and use of external service providers;
- increasing firm leadership responsibilities and accountability, and improving firm governance;
- more rigorous monitoring of quality management systems and remediating deficiencies;
- enhancing the engagement partner’s responsibility for audit engagement leadership and audit quality; and
- addressing the robustness of engagement quality reviews, including engagement selection, documentation, and performance.

Although the anticipated effective date of these standards is for audit periods after December 2021, practices should take steps to start understanding the proposed changes and consider the possible implications on quality control and audit methodology and procedures.

Our findings

Professional standards monitoring programme

The objective of the professional standards monitoring programme is ultimately to enhance the quality of financial reporting and the application of professional standards in Hong Kong. Under the programme, we carry out regular reviews of the financial statements of Hong Kong listed companies to assess their compliance with professional standards. This report summarizes the key observations from our reviews in 2019. We hope that members would find the discussions in this report insightful.



The main review focus of this programme for 2019 was on the initial application of two major financial reporting standards, HKFRS 9 (2014) *Financial Instruments* and HKFRS 15 *Revenue from Contracts with Customers* that became effective for financial reporting periods beginning on or after 1 January 2018. Therefore, in choosing financial statements for review, we gave priority to the financial statements of those industries which we expect more likely to be most significantly affected by these two standards. The key observations from our reviews are summarized in Section I below. Section II summarizes our key observations of the application of other financial reporting standards. Section III provides a summary of common disclosure deficiencies identified from our reviews.

Section I – Initial application of HKFRS 9 and HKFRS 15

HKFRS 9 (2014) and HKFRS 15 are complex financial reporting standards which have a wide-range impact on almost all reporting entities. The impact ranges from changes in the accounting policies and related accounting treatments to providing more extensive disclosures in financial statements. The application of HKFRS 15 might have impacted more on some industries but less on others. Therefore, the issues identified are categorized by industries such that members can gain more understanding of the implications of HKFRS 15 for different industries. Those issues might also be applicable to other industries depending on



their circumstances. The disclosure deficiencies are summarized at the end of this section.

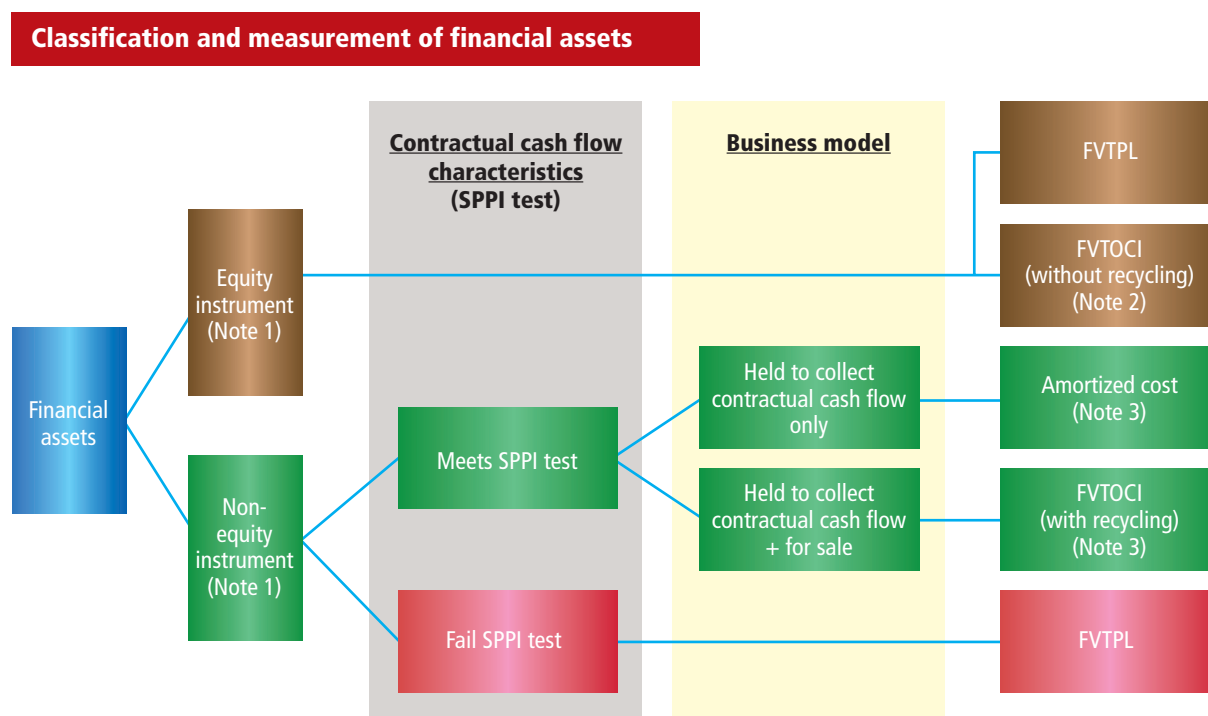
We will continue to place focus on reviewing the application of major new standards in our future reviews under this programme. Since HKFRS 16 *Leases* is another new and far reaching standard that has been effective for annual periods beginning on or after 1 January 2019, it will be our review focus in 2020.

1. HKFRS 9 (2014) *Financial Instruments*

HKFRS 9 (2014) that replaced HKAS 39 *Financial Instruments: Recognition and Measurement* sets out the requirements for classification and measurement of financial instruments, including impairment, derecognition and hedge accounting. As its scope is not industry-specific, all entities that have financial instruments other than those specifically scoped out under HKFRS 9 paragraph 2.1 (e.g. insurance contracts in the scope of HKFRS 4 *Insurance Contracts* or HKFRS 17 *Insurance Contracts* (effective from 1 January 2021)) need to assess the implications of HKFRS 9 (2014). However, members should note that some contracts to buy and sell non-financial items that would not meet the definition of financial instruments are within the scope of HKFRS 9 (2014) because they behave and are used in a similar way to financial instruments (HKFRS 9 (2014) paragraphs 2.4 to 2.7). In this part of the report, we focus on two major areas under HKFRS 9 (2014) that require more significant changes from HKAS 39: (i) classification of financial assets; and (ii) impairment assessment of financial assets under the expected loss model. The end of this section covers common disclosure deficiencies identified from our reviews.

(i) *Classification of financial assets*

A financial asset is classified into one of the three categories: (1) amortized cost; (2) fair value through other comprehensive income (“FVTOCI”); or (3) fair value through profit or loss (“FVTPL”). As shown in the diagram below, the classification and measurement of financial assets are determined based on the contractual cash flows characteristics and the business model within which the financial assets are held.



Note:

- Equity instrument cannot pass the SPPI test. Only debt instrument can pass.
- The FVTOCI option without recycling is only available for equity instrument that is not held for trading. It is an irrevocable option made at initial recognition (HKFRS 9 paragraph 5.7.5).
- A financial asset can be designated and measured at fair value through profit or loss if the fair value option is applied (HKFRS 9 (2014) paragraph 4.1.5)

An assessment of the “contractual cash flows characteristics” of a financial asset refers to an assessment of whether the contractual cash flows from the financial asset is consistent with a basic lending arrangement solely made up of, on specified dates, payments of principal and interest on the principal amount outstanding — SPPI test (HKFRS 9 (2014) paragraphs 4.1.2(b) and 4.1.2A(b)).

As shown in the above diagram, the “business model” test is another step that needs to be considered in the determination of the classification of a financial asset. As explained in HKFRS 9 (2014) paragraph 4.1.2A, an entity’s business model refers to how an entity manages its financial assets in order to generate cash flows. The entity’s business model determines whether cash flows will result from collecting contractual cash flows, selling financial assets or both. Consequently, this assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur, such as so-called “worst case” or “stress case” scenarios.

An entity’s business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity’s business model does not depend on management’s intentions for an individual instrument. Although the determination of the business model needs not be at the reporting entity level, the determination is not based on an instrument-by-instrument approach and should be on a higher level of aggregation. Accordingly, a single entity may have more than one business model for managing its financial instruments (e.g. one portfolio to collect contractual cash flows and another portfolio to trade to realize fair value changes) (HKFRS 9 (2014) paragraph B4.1.2)

HKFRS 9 (2014) paragraphs B4.1.4 and B4.1.4C respectively list out examples of a business model whose objective is achieved by holding financial assets to collect the contractual cash flows; and another business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. The lists are not exhaustive.

A reporting entity disclosed in its financial statements that it invested in some guaranteed corporate bonds, which were subject to repurchase (“Repo”) arrangements. Pursuant to the Repo arrangements, the reporting entity agreed to sell the corporate bonds to an independent party for a stated amount of consideration and repurchase the same corporate bonds on the repurchase date specified in the Repo agreements at a pre-agreed price. The reporting entity accounted for these corporate bonds as financial assets measured at amortized cost.

According to HKFRS 9 (2014) paragraph 4.1.2A, a financial asset shall be measured at FVTOCI if it is held within a business model whose objective is achieved by both collecting contractual cash flows which are solely payments of principal and interest on the principal amount outstanding and selling the financial asset. Given the limited information about the corporate bonds and how the Repo arrangements were structured (e.g. whether the corporate bonds contained a clause for subsequent sale or the Repo was a separate agreement), it was questionable how the classification of the corporate bonds at amortized cost (instead of FVTOCI) was justifiable.

In assessing the case, the QAD performed some research on the accounting implication for a Repo arrangement and noted that there is a market practice to regard a Repo arrangement as a financing arrangement under which the sold financial assets that will be repurchased by the entity from the buyers at a later date at an agreed price are not derecognized at the time when they are sold. HKFRS 9 (2014) paragraph B3.2.16 provides examples of various types of Repo agreements. In particular, HKFRS 9 (2014) paragraph B3.2.16(b) states that “If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender’s return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership” (underline added).

In the above example, the corporate bonds continued to be recognized on the reporting entity’s consolidated statement of financial position. It was also disclosed in its accounting policy that “Transfer of financial assets to third parties in transactions that do not qualify for derecognition are not considered as sales for the purpose of the business model assessment”. Despite the significance of the corporate bonds, there was no disclosure of information required by HKFRS 7 *Financial Instruments: Disclosures* paragraphs 42A and 42D and other information to enable users of the financial statements to understand how the management, based on the contract terms, performed the evaluation and applied their judgement in order to support the conclusion that (1) the corporate bonds should not be derecognized from the consolidated financial statements upon subsequent sales and that (2) under the Repo arrangements, the business model of holding the corporate bonds was only to collect the contractual cash flows and therefore it was appropriate to account for them at amortized cost (instead of FVTOCI).

The above example demonstrates (1) the need to carefully review the contract terms of the financial instruments in order to determine the proper accounting treatment; and (2) the importance of providing sufficient information on the critical judgement used in applying the accounting policy to determine the classification of financial instruments.

(ii) Impairment assessment of financial assets

The impairment model required by HKFRS 9 (2014) is an expected loss model, superseding the incurred loss model under HKAS 39. According to HKFRS 9 (2014) paragraph 5.5.1, the following instruments fall within the scope of the impairment requirements under HKFRS 9 (2014):

- Financial assets that are debt instruments measured at amortized cost or FVTOCI (e.g. loans, debt securities, bank balances and trade receivables);
- Lease receivables within the scope of HKAS 17 *Leases* or HKFRS 16 *Leases* (effective from 1 January 2019);
- Contract assets within the scope of HKFRS 15¹;
- Loan commitments that are not measured at FVTPL under HKFRS 9 (2014); and
- Financial guarantee contracts that are not measured at FVTPL under HKFRS 9 (2014).

As investments in equity instruments are measured at either FVTPL or FVOCI (not recycling), they are not subject to the impairment requirements of HKFRS 9 (2014).

Under the expected loss model, it is not necessary for a loss event to occur before an impairment loss is recognized. Expected credit losses (“ECLs”) are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of a financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses take into account the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due (HKFRS 9 (2014) paragraph B5.5.28).

Three approaches under HKFRS 9 (2014) for impairment assessment:

- Simplified approach
- General approach
- Purchased or originated credit-impaired approach

¹ *Contract asset* is defined as “an entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (e.g. the entity’s future performance) (HKFRS 15 Appendix A).

Under the *simplified approach*, an entity is not required to track changes in the credit risk but recognize a loss allowance based on lifetime ECLs at each reporting date. According to HKFRS 9 (2014) paragraph 5.5.15, this approach applies to trade receivables or contract assets that result from transactions within the scope of HKFRS 15 and that do not contain a significant financing component² (or when the entity applies the practical expedient for contracts that are one year or less).

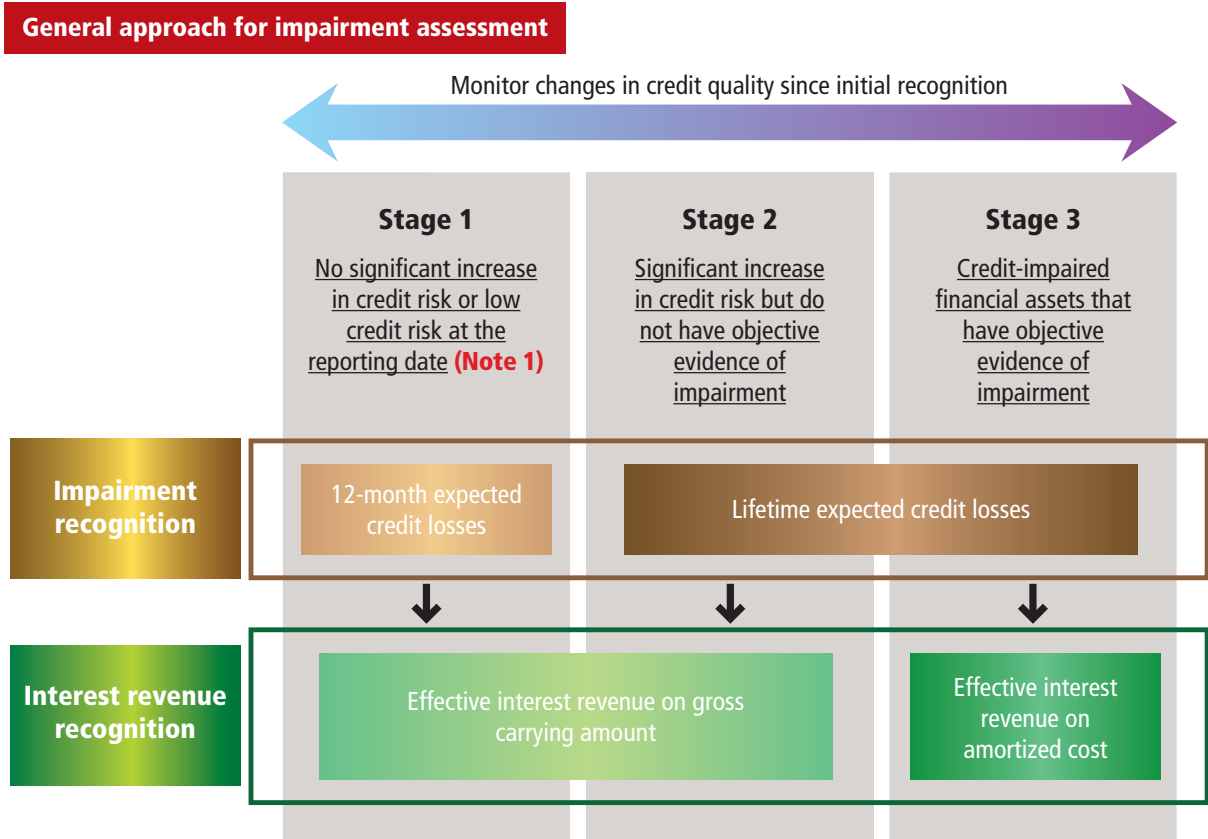
In respect of trade receivables or contract assets that result from transactions within the scope of HKFRS 15 and that contain a significant financing component, or lease receivables that result from transactions within HKAS 17 (or HKFRS 16 from 1 January 2019), an entity has an accounting policy choice to use either the *simplified approach* (i.e. to measure the loss allowance at an amount equal to lifetime ECLs at initial recognition and throughout its life) or the *general approach*.

Under the *general approach*, at each reporting date, an entity recognizes a loss allowance based on a calculation of either 12-month ECLs or lifetime ECLs depending on whether there has been a significant increase in credit risk on the financial instrument since its initial recognition (HKFRS 9 (2014) paragraphs 5.5.3 and 5.5.5). There are three stages under the *general approach*. A point to note is that, if the credit quality of a financial asset subsequently deteriorates to a point that the financial asset becomes credit-impaired³ (i.e. Stage 3), but it is not a purchased or originated credit-impaired financial asset, lifetime ECLs are recognized (which is the same as Stage 2). However, the interest revenue of such financial asset is calculated on the net carrying amount (i.e. net of allowance for ECLs), which is different from Stage 1 and Stage 2 under which interest revenue is calculated on the gross carrying amount. Any impairment loss (or gain) resulting from the changes in the loss allowance is recognized in profit or loss as required by HKFRS 9 (2014) paragraph 5.5.8.

² The requirements for determination of whether a significant financing component exists in the contract are provided in HKFRS 15 paragraphs 60 to 65.

³ Appendix A to HKFRS 9 (2014) provides examples of evidence that show a financial asset is "credit-impaired". Those examples are consistent with those included in HKAS 39 paragraph 59 for identifying objective evidence of impairment, e.g. significant financial difficulty of the issuer or the borrower; a default or past due event; the disappearance of an active market for that financial asset because of financial difficulties, etc.

The following diagram summarizes the *general approach* used in the impairment assessment under HKFRS 9 (2014).



Note:

1. In respect of financial assets with low credit risk at the reporting date, an entity can apply the practical expedient to measure impairment using 12-month ECLs such that it does not have to assess whether there has been a significant increase of those financial assets since initial recognition. However, the entity can choose to apply the “general approach” for impairment assessment of those financial assets (HKFRS 9 (2014) paragraph 5.5.10)

The *purchased or originated credit-impaired approach* refers to an entity’s assessment to determine whether the financial asset is credit-impaired⁴ on initial recognition. A financial asset is considered as credit-impaired on purchase or origination if there is evidence of impairment on initial recognition. Impairment of a purchased or originated credit-impaired financial asset is determined based on full lifetime ECLs using the credit-adjusted effective interest rate determined at initial recognition (HKFRS 9 (2014) paragraph B5.5.45).

The following issues relating to the determination of ECLs were identified from our 2019 reviews:

(a) Initial application

HKFRS 9 (2014) shall be applied retrospectively in order to compute the cumulative effect of the new measurement requirements. However, comparatives are not required to be restated and an entity is only permitted to restate comparatives if it can do so without applying hindsight. None of the financial statements reviewed had restated comparatives upon initial application of HKFRS 9 (2014).

⁴ Same as footnote 3.

If the comparatives are not restated, HKFRS 9 (2014) requires an entity to adjust the opening balance of retained earnings in the year of initial application for the cumulative effect of applying HKFRS 9 (2014). Under this requirement, entities shall measure the financial asset at the date of initial adoption of HKFRS 9 (2014) (i.e. 1 January 2018 for December financial year end) and adjust any cumulative effect of applying HKFRS 9 (2014) to the opening balance of retained earnings.

In addition, HKFRS 7 paragraph 42P requires an entity, on the date of initial application of HKFRS 9 (2014), to disclose information that would permit the reconciliation of the ending impairment allowances in accordance with HKAS 39 and the provisions in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening loss allowances determined in accordance with HKFRS 9 (2014).

As mentioned above, HKFRS 9 (2014) uses an expected loss model as compared to an incurred loss model that was used in HKAS 39. In some examples reviewed, no adjustments were found to have been made to the opening balance of retained earnings despite the disclosure that the expected loss model under HKFRS 9 (2014) had been applied. For example, a reporting entity disclosed that it had applied the simplified approach under HKFRS 9 (2014) to measure the lifetime ECLs for its trade receivables. Except for those receivables which were credit-impaired, the reporting entity determined the ECLs on trade receivables by using a provision matrix grouped by past due dates. An impairment loss allowance was recognized at the end of the reporting period but none for the opening balance of trade receivables at the beginning of the reporting period. It was questionable as to whether the reporting entity had applied the same measurement basis under HKFRS 9 for the trade receivable balances as of the beginning of the reporting period (on the date of the transition). Enquiries were therefore raised with the auditor about the management's assessment and their work done to support the conclusion that no adjustment to the opening balance was required.

(b) Loans due from joint ventures

There were two review cases in which the reporting entities had loans due from their joint ventures but no expected credit loss allowances were provided on these loans despite the fact that the joint ventures had net liabilities and were making losses. One of the reporting entities disclosed that the reporting entity had performed an impairment assessment on the loans due from the joint venture and concluded that the probability of defaults was insignificant and accordingly no allowance for credit losses was provided. Another reporting entity had already ceased sharing the losses of the joint venture under the equity method as its share of the loss exceeded its interest in the joint venture and it had no obligation to take up further losses. In both examples, no disclosures were made to explain management's justifications for not providing any expected credit losses on the loans due from the joint ventures under HKFRS 9 (2014) and/or the critical judgement applied and estimates used in applying the accounting policy for determining impairment of financial assets. Therefore, an enquiry was raised with the auditor of the case assessed to have a more significant financial impact. In its response, the auditor provided more information about the joint venture and explained how management took into account both past information and forward-looking information such as sales forecast and relevant local government policies to support the conclusion that the joint venture should have sufficient funds to repay the loans and therefore no allowance for ECLs was required to be recognized.

In theory, except for credit-impaired financial assets determined at initial recognition for which no loss allowances will be recognized, all financial assets should have an expected loss allowance provided under the expected loss model of HKFRS 9 given that there is always a possibility that a credit loss might occur even if the most likely outcome is no credit loss (HKFRS 9 (2014) paragraph B5.5.41). The estimation of ECLs is not made based on the worst-case scenario nor the best-case scenario. In the above case, an allowance for ECLs should, in theory, have been recognized even though the amount to be recognized might not be significant under the expected loss model of HKFRS 9 (2014).

Entities should consider all reasonable and supportable information including that which is forward-looking in (1) assessing whether a financial instrument has had a significant increase in its credit risk since its initial recognition and (2) the determination of ECLs (HKFRS 9 (2014) paragraph 5.5.4). When reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess the changes in credit risk and an entity cannot solely rely on past due information (HKFRS 9 (2014) paragraphs 5.5.11 and B5.5.2).

(c) Impairment of bill receivables and other receivables

As discussed above, under HKFRS 9 (2014) paragraph 5.5.15, the simplified approach for measuring expected credit losses is only applicable to trade receivables and contract assets within the scope of HKFRS 15 and lease receivables within the scope of HKAS 17 (or HKFRS 16 from 1 January 2019).

However, we identified in some cases that there were some financial assets which appeared not to have qualified for the use of the simplified approach under HKFRS 9 (2014) paragraph 5.5.15 (e.g. bill receivables and other receivables which are not trade receivables, contract assets or lease receivables) but the reporting entities had used the simplified approach to measure their ECLs (i.e. measured at an amount equal to its lifetime ECLs with no tracking of the changes in credit risks). Should the general approach have been used, an assessment would have been needed to identify whether there had been a significant increase in credit risk since their initial recognition. The ECLs would have been calculated by evaluating the financial assets through applying the three-stage model (i.e. Stage 1 – 12-month ECLs; Stage 2 – Lifetime ECLs for not credit-impaired financial asset; and Stage 3 – Lifetime ECLs for credit-impaired financial asset) as shown in the above diagram.

The simplified approach provides operational simplifications such that an entity does not need (1) to calculate 12-month ECLs and (2) to assess when a significant increase in credit risk has occurred. However, an entity shall assess whether the financial assets are qualified for the use of the simplified approach under HKFRS 9 (2014) paragraph 5.5.15 or else the general approach shall be used.

One of the challenges in using the general approach is to track and determine whether there has been a significant increase in credit risk of a financial asset since its initial recognition. HKFRS 9 (2014) paragraph B5.5.21 specifies that an entity cannot align the timing of significant increases in credit risk and the recognition of lifetime ECLs with the time when the financial asset is regarded as credit-impaired or to an entity's internal definition of default. Normally, a financial asset should be assessed as having its credit risk increased significantly earlier than when it becomes credit-impaired or an actual default occurs (HKFRS 9 (2014) paragraph B5.5.7). Accordingly, under HKFRS 9, it is presumed that there has been a significant increase in credit risk since initial recognition when the contractual payments of a financial asset are 30 days past due⁵ (HKFRS 9 (2014) paragraph 5.5.11) and that later on the financial asset is considered to be in default if it is 90 days past due (HKFRS 9 (2014) paragraph B5.5.37), although both presumptions are rebuttable.

(d) Definition of default

HKFRS 9 (2014) paragraph B5.5.37 states that *"When defining default for the purposes of determining the risk of a default occurring, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate" (underline added).*

In an example reviewed, the accounting policy for impairment of financial assets mentioned that the reporting entity considered a financial asset to be in default when (1) the borrower was unlikely to make repayments in full; or (2) the financial asset is more than 180 days past due. There was, however, no disclosure of the reason(s) for setting the "default criterion" as "180 days past due" as required by HKFRS 7 paragraph 35F(b). Therefore, an enquiry was raised asking the auditor to provide information about the reporting entity's rationale and justification for rebutting the "90 days past due" presumption set out in HKFRS 9 (2014) paragraph B5.5.37 and the audit work performed to assess the sufficiency and appropriateness of the management's justification for rebutting the "90 days past due" presumption.

It is worth noting that, the purpose of the rebuttable presumption is not to delay the default event until a financial asset becomes 90 days past due, but to ensure that entities will not define default later than that point without reasonable and supportable information to substantiate the assertion (HKFRS 9 (2014) BC5.253). An entity is also required to consider qualitative indicators of default when appropriate (HKFRS 9 (2014) BC5.252).

⁵ To supplement the requirement to determine the extent of increases in credit risk since initial recognition, and to ensure that its application does not revert to an incurred loss notion, the IASB proposed a rebuttable presumption that the credit risk on a financial instrument has increased significantly, and that lifetime expected credit losses shall be recognized, when a financial asset is more than 30 days past due (HKFRS 9 BC5.190).

(iii) Disclosure deficiencies

HKFRS 7 was amended as a result of the introduction of HKFRS 9 (2014). The amended HKFRS 7 sets out new and expanded disclosure requirements covering a number of areas, e.g. those concerning credit risk and expected credit losses, reclassification of financial assets from one measurement category to another, designation of equity investments at FVTOCI, designation of financial liabilities at FVTPL and hedge accounting.

The following disclosures with regard to credit risk and expected credit losses were commonly omitted:

- quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes (HKFRS 7 paragraph 35B(b));
- how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how the presumption in HKFRS 9 (2014) paragraph 5.5.11, that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted (HKFRS 7 paragraph 35F(a)(ii));
- an entity's definitions of default, including the reasons for selecting those definitions (HKFRS 7 paragraph 35F(b));
- by credit risk rating grades, the gross carrying amount of financial assets for which the loss allowance is measured at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses (HKFRS 7 paragraph 35M (a) and (b));
- the basis of inputs, assumptions and the estimation techniques used to measure the 12-month and lifetime expected credit losses; and how forward-looking information has been incorporated into the determination of expected credit losses (HKFRS 7 paragraph 35G(a)(i) and (b)); and
- a reconciliation from the opening balance to the closing balance of the loss allowance account on account receivables and other receivables to show separately the changes during the period for the loss allowance measured at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses and those financial assets that are purchased or originated credit-impaired (HKFRS 7 paragraph 35H).

2. HKFRS 15 Revenue from Contracts with Customers

HKFRS 15 establishes a single source of revenue guidance, superseding nearly all revenue recognition guidance under HKFRSs. HKFRS 15 specifically covers revenue that arises from a contract when the counterparty to that contract is a customer and the contract is not specifically excluded from HKFRS 15 as it is within the scope of other standards.

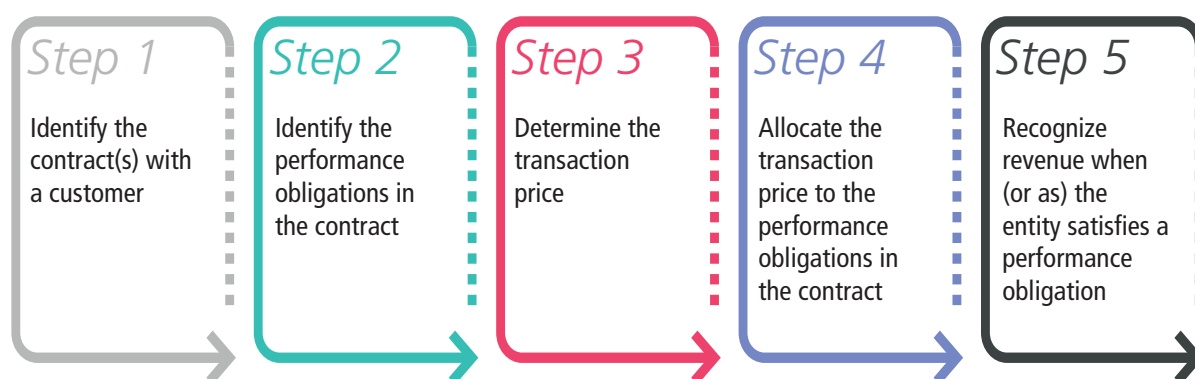
A “customer” is a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration (HKFRS 15 paragraph 6). Therefore, a counterparty in a contract which only participates in, and shares the risks and benefits that result from, an activity or a process instead of obtaining output of the entity’s ordinary activities is not regarded as a customer and therefore a contract with such party is not within the scope of HKFRS 15.

Contracts that are outside the scope of HKFRS 15 include lease contracts within the scope of HKFRS 16 *Leases* (or HKAS 17 *Leases*) and financial instruments and other contractual rights or obligations within the scope of HKFRS 9 (2014) (HKFRS 15 paragraph 5). An entity shall consider the contract terms and all relevant facts and circumstances when applying HKFRS 15 and apply HKFRS 15 consistently to contracts with similar characteristics and in similar circumstances (HKFRS 15 paragraph 3).

Core principle of HKFRS 15

The core principle of HKFRS 15 is that an entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services (HKFRS 15 paragraph 2). As compared to previous revenue standards (e.g. HKAS 18 *Revenue*) that require revenue to be recognized when risks and rewards of ownership are transferred to a customer, HKFRS 15 uses a “control model” requiring an entity to recognize revenue when (or as) it satisfies a performance obligation, i.e. when (or as) **control** of goods or services underlying the performance obligation is transferred to the customer. A new five-step model laid down in HKFRS 15 provides guidance on recognition of revenue from contracts with customers, particularly on when to recognize and how much is to be recognized. Issues identified from the application of the five-step model are further discussed below.

Five-step model



On initial application of HKFRS 15, an entity is not permitted to apply HKFRS 15 on a full prospective basis (i.e. it cannot apply HKFRS 15 only to contracts entered into after the effective date of HKFRS 15). Instead, it applies either:

- (a) *the retrospective method* – retrospectively adjusting each comparative period presented, with a choice of practical expedients; or
- (b) *the cumulative method* – recognizing the cumulative effect of initially applying HKFRS 15 at the beginning of the year of initial application, with a choice of practical expedients.

All the financial statements reviewed showed that the cumulative method (see (b) above) was used upon initial application of HKFRS 15 and no major non-compliance was identified in respect of the transition.

HKFRS 15 Appendix B provides implementation guidance and sets out illustrative examples for specific transactions including sales with a right of return, warranties, principal versus agent considerations (gross versus net presentation), licences, customer acceptance, and etc. The issues discussed below cover some of the above topics. **Please note that the observations below are summarized based on our 2019 reviews and therefore are not exhaustive.**

(i) *Property development companies*

Sales incentives

It is not uncommon for property developers to offer different sales incentives to entice their customers to purchase their properties. For example, a property developer may offer customers an option to purchase additional apartment units or a car park space at a discount to the list price. Some developers may offer reimbursement to customers for the legal fees and stamp duties incurred. These sales incentives have different accounting implications under HKFRS 15 which are further discussed below.



Under HKFRS 15, entities are required to identify, at contract inception, all promised goods and services in the contract (e.g. under a provisional sale and purchase agreement) and to determine whether each promised good or service represents a separate performance obligation. HKFRS 15 paragraph B40 states that, if in a contract, an entity grants a customer an option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that the customer would not receive without entering into that contract. If, in the case of a property dealing, the option provides a material right to the customer, the customer in effect pays the developer in advance for future goods or services and the developer recognizes revenue when those future goods or services are transferred or when the option expires. Property developers should consider this requirement to ensure that all performance obligations within the contract are identified.

Reimbursement of legal fees and stamp duties by property developers are considered a form of consideration payable to customers, for which the relevant accounting requirements are set out in HKFRS 15 paragraph 70. The standard states that “consideration payable to a customer” includes a cash amount that an entity pays, or expects to pay, to the customer. It also includes credit or other items (e.g. a coupon or voucher) that can be applied against the amounts owed by a customer to the entity. To determine an appropriate accounting treatment, an entity shall first determine whether the payment to a customer is in exchange for a distinct good or service that the customer transfers to the entity. If not, the consideration payable to a customer shall be accounted for as a reduction of the transaction price, thereby reducing the amount of revenue to be recognized.

We encountered issues where there was no or insufficient information in the financial statements of property developers to explain how the different sales incentives offered by them and other sales arrangements were accounted for in order to support that the relevant requirements of HKFRS 15 had been adequately considered and appropriately applied by the reporting entities. In an example reviewed, the financial statements disclosed that, depending on market conditions, the reporting entity might offer customers a discount compared to the listed sales price, provided that the customers agreed to pay the balance of the consideration early while construction of properties was in progress. There was neither an accounting policy nor other information disclosed in the financial statements to provide information about how the reporting entity accounted for such discounts, e.g. whether or not such discounts to customers were accounted for as a reduction of revenue.

Apart from the above, other aspects of HKFRS 15 might also have a significant impact on property developers’ accounting for revenue, e.g. the timing of recognition of revenue (“over time” versus “at a point in time”); adjustments to the transaction price for revenue recognition when significant financial component exists; and capitalization of incremental costs (e.g. sales commissions), etc. We shall share with members other issues when they are identified in future reviews.

(ii) Trading and retail companies

Principal versus agent evaluation

Instances were identified which raised questions about whether sufficient consideration had been given to the requirements of HKFRS 15 to support the conclusion that the reporting entities acted as principals and not agents in the transactions. A principal recognizes its revenue on a gross basis but revenue recognition is on a net basis for an agent (i.e. recognition of the fee or commission).

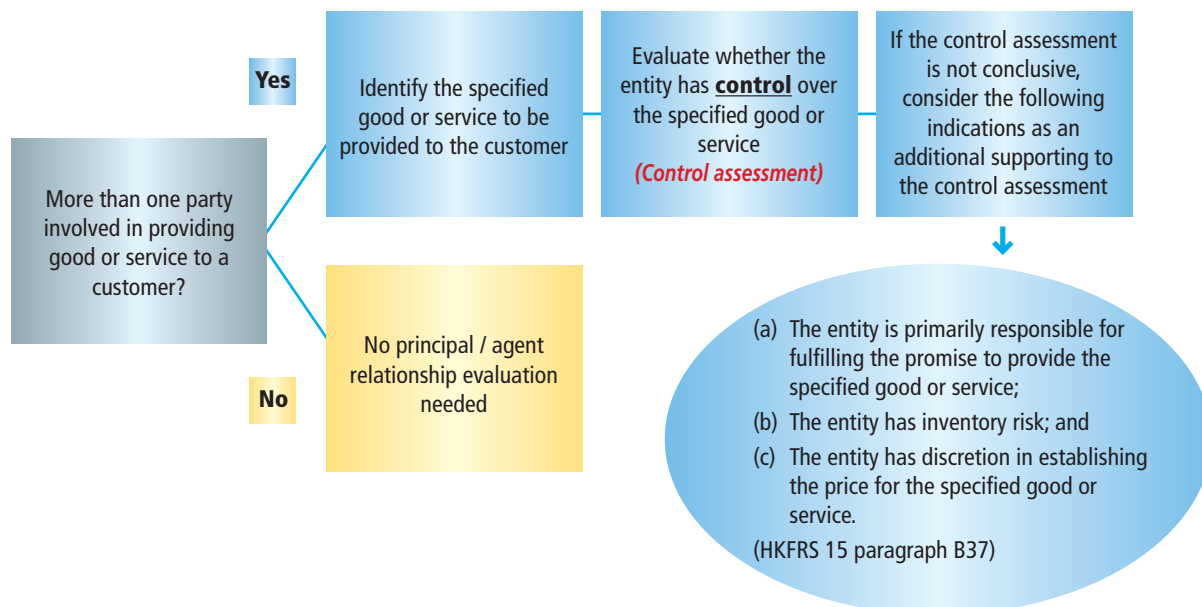
A reporting entity engaged in a trading business of technological products disclosed in its financial statements that it had only one customer for its trading business. The reporting entity did not keep any inventories and only earned a low profit margin from its trading business. The information provided in the Management Discussion and Analysis section of the annual report mentioned that the reporting entity was facing more keen competition from trading agents in other countries vying for a share of the same market of technological products as more manufacturers were moving to other countries to lower their production costs.

In the above example, the gross presentation of revenue suggested that the reporting entity regarded itself as a principal in its trading business of technological products. However, other information provided in the annual report (e.g. the competitors being trading agents and no bearing of inventory risks) raised doubts about whether the reporting entity in fact acted as an agent for the manufacturers. In addition, no information about the business model of the reporting entity was provided in the annual report to enable readers to understand how businesses were arranged, e.g. whether the trading business was transacted on an indent basis such that no inventories were kept by the reporting entity. The accounting policy for revenue recognition was also rather generic without addressing specifically the circumstances of the reporting entity as a trading company. There was also no disclosure of the critical judgement applied by the reporting entity to support its conclusion that it was a principal in its trading business. Accordingly, enquiries were raised to ask the auditor to provide explanation, in particular how the gross presentation of revenue was justifiable and the judgement applied in the management's assessment.

The determination of whether the entity is acting as a principal or an agent not only affects the amount of revenue to be recognized (i.e. gross for a principal versus net for an agent), it might also affect the timing for recognizing such revenue. A principal would recognize revenue when (or as) it transfers the specified good or service to the customer. An agent would recognize revenue when its performance obligation to arrange for the specified good or service is complete. Therefore, a proper evaluation of the entity's capacity as a principal or an agent in a transaction is essential. The flow diagram below summarizes the HKFRS 15 requirements in regards to a "principal versus agent" evaluation⁶.

⁶ HKFRS 15 requires an entity to determine whether it is a principal or an agent in a transaction which involves more than one party in providing goods or services to a customer. However, the IASB considers that if an entity itself is a manufacturer, it does not need to evaluate the principal versus agent application guidance because it transfers control of or provides its own good or service directly to its customer without the involvement of another party (HKFRS 15 paragraph BC385E).

Determination of principal versus agent



Members may note that the indicators for principal versus agent evaluation provided in HKFRS 15 are similar to those in the previous revenue standard (HKAS 18). However, as shown in the above diagram, the key difference as compared to HKAS 18 is that HKFRS 15 focuses on a “control” assessment⁷ - i.e. whether the entity controls a specified good or service before it is transferred to the customer. If the control assessment performed based on the general guidance of HKFRS 15 is not conclusive, the entity should then consider the indicators provided in HKFRS 15 paragraph B37 when determining whether it acts as a principal. Those indicators are not exhaustive. As an entity needs to first perform the control assessment before reviewing those indicators, this could result in a different conclusion as compared to that was reached under HKAS 18.

Members are reminded that obtaining the legal title of a specified good momentarily before transferring the legal title to a customer does not necessarily evidence control (HKFRS 15 paragraph B35). Significant judgement may need to be applied when applying the application guidance in the principal versus agent evaluation. The significant judgement applied should be disclosed in the financial statements in accordance with HKAS 1 (Revised) *Presentation of Financial Statements*.

⁷ The description of control is provided in HKFRS 15 paragraph 33, which states that “Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset. The benefits of an asset are the potential cash flows (inflows or savings in outflows) that can be obtained directly or indirectly in many ways, such as by: (a) using the asset to produce goods or provide services (including public services); (b) using the asset to enhance the value of other assets; (c) using the asset to settle liabilities or reduce expenses; (d) selling or exchanging the asset; (e) pledging the asset to secure a loan; and (f) holding the asset” (underline added).

The principal versus agent evaluation has also particular relevance to gaming companies, e.g. whether an online game company is the principal when hosting another entity's gaming software (i.e. online games) on its platform. As stated, the evaluation should be carried out based on the "control assessment" under HKFRS 15.

The FASB/IASB Joint Transition Resources Group for Revenue Recognition ("TRG") discussed in its July 2014 meeting the potential implementation issues in relation to determination and accounting for whether an entity is a principal or an agent to contracts for certain intangible goods or services. Members are advised to refer to the relevant staff paper and meeting summary for more understanding of those issues and they are available at: <https://www.ifrs.org/groups/transition-resource-group-for-revenue-recognition/#meetings>

Sales with a right of return

Sales with a right of return are common for a retail business and some other industries such as manufacturing and trading companies. Normally, the amount of sales return should not be significant as compared to the total revenue recognized by the entities and therefore the related accounting might be easily overlooked or neglected. Although the accounting requirements for sales with a right of return under HKFRS 15 have not changed significantly as compared to HKAS 18, there are differences and new concepts introduced, which would be further discussed after sharing the following example.

According to the Management Discussions and Analysis section of the annual report of a reporting entity reviewed, the reporting entity had different channels of sales of its apparel products, including sales to distributors and sales through both on-line and self-operated stores.

Although the financial statements disclosed that the initial adoption of HKFRS 15 did not have a material impact on the reporting entity's financial statements, the limited disclosures relating to the application of HKFRS 15 raised doubts on whether the reporting entity had properly assessed and complied with all relevant HKFRS 15 requirements based on its own circumstances. In particular, there was no information disclosed about when the reporting entity typically satisfied its performance obligations, what were the significant payment terms (e.g. when the payment was typically due, whether the contract had a significant financing component, whether the consideration amount was variable and whether the estimate of the variable consideration was typically constrained) and what were the obligations for returns, refunds and other similar obligations (HKFRS 15 paragraph 119).

In regards to the sales with a right of return, the reporting entity mentioned in a note disclosure that its turnover represented the sales value of goods less returns, discounts and value-added tax. This information suggested that (1) the reporting entity granted return rights to its customers and (2) the sales consideration might vary depending on the discounts given. However, no relevant accounting policy nor further details of the return rights (e.g. the period allowed for goods to be returned and any assets and refund liabilities recognized under HKFRS 15 paragraph B21) were provided in the financial statements.

According to HKFRS 15 paragraph B22, a right of return does not represent a separate performance obligation. Instead, it affects the transaction price and the amount of revenue to be recognized for a satisfied performance obligation (i.e. falling under *Step 3 Determining the transaction price* under the five-step model).

HKFRS 15 paragraph B21 specifies the accounting treatment of sales with a right of return. It states that, “*To account for the transfer of products with a right of return (and for some services that are provided subject to a refund), an entity shall recognise all of the following:*

- (a) revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognised for the products expected to be returned);*
- (b) a refund liability; and*
- (c) an asset (and a corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability”.*

Under the above requirement, revenue should not be recognized for goods expected to be returned. Instead, a “refund liability” should be recognized for expected refunds to customers. The asset as referred to HKFRS 15 paragraph B21(c) is initially measured at the cost of inventory sold less any expected costs to recover the goods (including any potential decreases in the value to the entity of returned goods). Both “refund liability” and the “asset” should be subsequently remeasured and updated at the end of the reporting period based on changes in expectations about the products to be returned and the amount of refunds. Any changes in estimates are adjusted against the asset and the liability, with corresponding adjustments recorded to revenue and adjustments to the asset recorded against cost of sales. The asset and refund liability must be presented separately on a gross basis and shall not be offset (HKFRS 15 paragraphs B24 and B25). Members may refer to Example 22 set out in HKFRS 15 IE110 to IE115 for more understanding of the application of the above requirements.

In another example reviewed, the reporting entity disclosed that it used the expected value method and gave consideration to historical experience in calculating the refund liabilities which were material to the financial statements. However, there was no disclosure in the financial statements about the methods, inputs and assumptions used for measuring obligations for the refunds as required by HKFRS 15 paragraph 126(d) and key sources of estimation uncertainty required by HKAS 1 (Revised) paragraph 125 with regard to the estimation of refund liabilities.

Members should note that under HKFRS 15, rights of return do not include exchanges by customers of one product for another of the same type, quality, condition and price (e.g. one colour or size for another) (HKFRS 15 paragraph B26). Exchanges of defective products for a functioning product are also not regarded as rights of returns but instead shall be evaluated in accordance with the guidance on warranties (HKFRS 15 paragraph B27).

HKFRS 15 requires an entity to treat the right of return as a type of variable consideration to which the requirements for constraining estimates of variable consideration apply (HKFRS 15 paragraph B23), which is further discussed below.

Variable consideration

With regard to the above example, the turnover of goods of the reporting entity was determined as sales value of goods less sales returns and sales discount. As for the sales with a right of return, the financial statements of the reporting entity were silent as to what was the impact on revenue recognition arising from sales discounts, specifically, whether the discounts were regarded as a form of variable consideration; and if so, the relevant accounting policy and required disclosures relating to variable consideration (e.g. information about the methods, inputs and assumptions for estimating variable consideration and assessing whether an estimate of variable consideration is constrained required by HKFRS 15 paragraph 126) were omitted from the financial statements. Due to the lack of disclosures, it was unclear whether the requirements under HKFRS 15 on the accounting for variable consideration were complied with.

HKFRS 15 paragraph 51 provides a broad description of variable consideration, which includes discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or similar items. Therefore, in the commercial world, many entities would have transactions with variable consideration. A typical example is when entities give sales discounts based on the volume of goods ordered by their customers. Members should therefore be mindful of the requirements of HKFRS 15 to ensure that the variable consideration recognized is appropriate. Example 24 in HKFRS 15 paragraphs IE124 to IE128 illustrates that an ongoing assessment by the entity is needed for determining the revenue to be recognized when the transaction involves “sales volume discounts”⁸.

HKFRS 15 requires some or all of an amount of variable consideration to be included in the transaction price only to the extent that it is *highly probable* that a *significant reversal* in the amount of cumulative revenue recognized *will not occur* when the uncertainty associated with the variable consideration is subsequently resolved (HKFRS 15 paragraph 56). This approach is not a policy choice. Entities shall consider both the *likelihood* and the *magnitude* of the revenue reversal. Some example factors for consideration are provided in HKFRS 15 paragraph 57. Significant judgement might be required to estimate the variable consideration for inclusion in the transaction price being recognized as revenue.

Many companies offer warranties to their customers to provide protection to their end customers for defects arise during the warranty periods. Therefore, “warranties” is an area in HKFRS 15 that commonly affects retail and trading companies and other industries. However, we discussed “**Warranties**” in part (iii) below instead of part (ii) (Trading and retail companies) as the issue identified was from the review of the financial statements of an information technology company.

⁸ Volume discount can be in form of variable consideration or a customer option to purchase additional goods at a discount. The difference between the two is that the latter is an additional performance obligation in an arrangement if the option provides the customer with a material right (see discussions in “Sales incentives” above)

(iii) Information technology companies, online game service providers and other service providers

Bundled sales transactions – sales of goods and provision of services

HKFRS 15 paragraph 76 states that “To allocate the transaction price to each performance obligation on a relative stand-alone selling price basis, an entity shall determine the stand-alone selling price at contract inception of the distinct good or service underlying each performance obligation in the contract and allocate the transaction price in proportion to those stand-alone selling prices” (underline added). (i.e. Step 4 Allocating transaction price to performance obligations in the contract” in the five-step model.) HKFRS 15 paragraph 79 provides three approaches for estimating the stand-alone selling price of a good or service when the stand-alone selling price is not directly observable: (a) the adjusted market assessment approach; (b) the expected cost plus a margin approach; and (c) the residual approach. The following example concerns the application of the residual approach:

A set of financial statements reviewed disclosed that the reporting entity was engaged in two principal activities: (1) design and development of routers and (2) provision of software licences and warranty and support services; and had bundled sales transactions. According to the information provided in the Key Audit Matters section of its auditor’s report, in accounting for its bundled sales transactions, the reporting entity allocated the transaction price to each element in the contract with reference to its relative fair value (i.e. stand-alone price). In case where management was unable to directly observe the stand-alone selling price, the “residual value method” was used to estimate the stand-alone selling price by reference to the total contract consideration less the sum of the observable stand-alone selling prices of other elements. The issue in this example is whether the “residual value method” applied by the reporting entity was justifiable under HKFRS 15.

HKFRS 15 paragraph 79(c) states that an entity may use a residual approach to estimate the stand-alone selling price of a good or service only if one of the two criteria is met:

- *Criterion 1* – the entity sells the same good or service to different customers for a broad range of amounts and therefore historical selling price is highly variable; or
- *Criterion 2* – the entity has not yet established a price for that good or service and the good or service has not previously been sold on a stand-alone basis. (i.e. the selling price is uncertain).

The auditor’s report only stated that the reporting entity applied the “residual value method” when it was unable to directly observe the stand-alone price. It was unclear whether either of the two conditions set out in HKFRS 15 paragraph 79(c) had been fulfilled. An enquiry was therefore raised in this respect.

In response to our enquiry, the auditor provided more information about the bundled sales transactions entered into by the reporting entity and how Criterion (2) was considered to have been met. The auditor explained that the bundled sales transactions involved sales of a specific type of routers and provision of warranty services. The reporting entity chose to use the residual approach to establish the selling price of the routers because it had not established a stand-alone selling price for that specific type of routers and that type of routers had never been previously sold on a stand-alone basis. We noted that the subsequent financial statements of the reporting entity had provided further disclosure of the estimation of the stand-alone selling price using the residual value method in its notes on key estimation uncertainties.

It is worth noting that the use of the residual approach provided under HKFRS 15 cannot result in a stand-alone selling price of zero if the good or service is distinct. This is because a good or service must have value on a stand-alone basis to be distinct. If the use of the residual approach results in no, or very little, consideration being allocated to a good or service or a bundle of goods or services, an entity should consider whether the estimate is appropriate in those circumstances (HKFRS 15 BC paragraph 273).

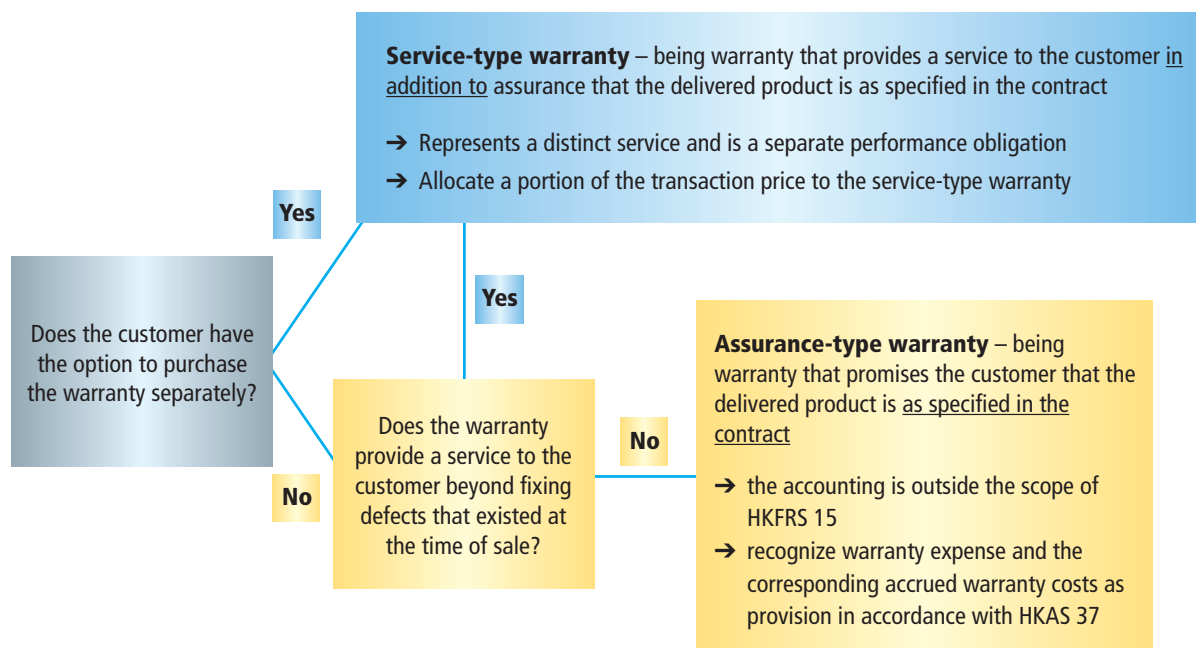
A combination of methods may need to be used to estimate the stand-alone selling prices of goods or services promised in a contract if two or more of those goods or services have highly variable or uncertain stand-alone selling prices (HKFRS 15 paragraph 80).

Warranties

The reporting entity of the above example earned a significant amount of revenue from provision of warranty and support services. The relevant accounting policy disclosed in the financial statements generally stated that revenue from the provision of warranty and support services was recognized over the scheduled period because the customer simultaneously receives and consumes the benefits provided by the reporting entity.

HKFRS 15 provides specific guidance on the accounting for warranties. The above disclosures revealed that the warranty and support services were identified as a separate performance obligation and the revenue derived from the provision of such services was recognized over time. However, there was no further information provided in the financial statements about the nature of the warranty and support services provided by the Group and whether the treatment adopted by the reporting entity to account for such services was in accordance with the requirements of HKFRS 15. The following diagram summarizes the relevant accounting requirements set out in HKFRS 15 paragraph B29 and B30 on warranties:

Warranties



In view of the lack of information provided in the financial statements, enquiries were raised to ask the auditor to provide information about the warranty and support services provided by the reporting entity and the audit work performed to satisfy itself that the reporting entity's accounting treatment complied with HKFRS 15.

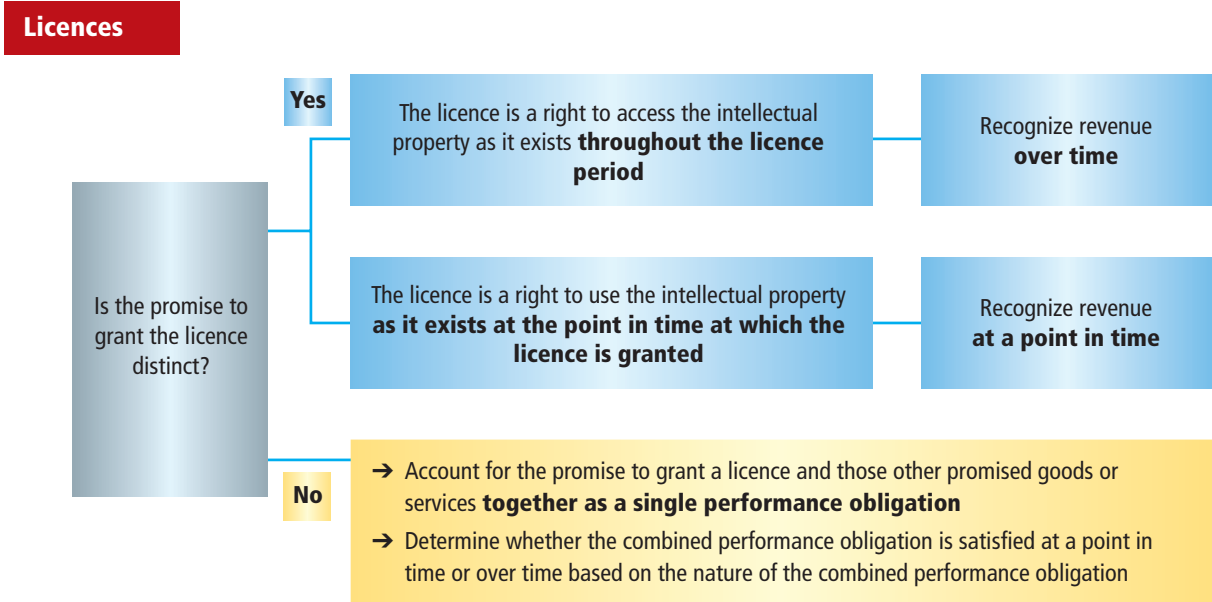
In the auditor's response, further details about the warranty services were provided. Two types of warranty services were provided: one was embedded in the bundled sale transactions (as discussed in "***Bundled sales transactions – sales of goods and provision of services***" above) and the other was sold by the reporting entity separately. The auditor also explained that the first type of warranty services (i.e. the embedded warranties) was regarded as a separate performance obligation as the customers were provided with a service beyond fixing the existing defects in the products although the customers were not given an option to purchase such service separately. In respect of the second type of warranty services, the warranties with coverage of 1 to 2 years were sold separately by the reporting entity.

In the above example, without the auditor's explanation, it would have been difficult for users of the financial statements to understand the warranty nature and the circumstances under which the warranty services were provided to customers. In particular, HKFRS 15 identifies two types of warranties: 1) assurance-type warranties and 2) service-type warranties of which the accounting treatments are different (see the diagram above). Given the significance of revenue generated from provision of warranty services, the auditor was recommended to advise the reporting entity to (1) provide appropriate details about the warranty services provided to customers and (2) expand its accounting policy to explain the different accounting treatments of the two types of warranties in its financial statements such that users of financial statements can have more understanding of the basis for the related accounting. We noted that the subsequent financial statements of the reporting entity had taken into account our advice on the above and provided more disclosures.

Licences of intellectual properties

According to the Management Discussion and Analysis of an annual report of the reporting entity, a source of revenue of the reporting entity came from granting of software licences. The disclosed accounting policy generally stated that the revenue generated from the provision of licence services was recognized over the scheduled period because the customer simultaneously receives and consumes the benefits provided by the reporting entity.

HKFRS 15 paragraphs B54 to B56 provide specific guidance on the accounting for licences of intellectual properties. According to the guidance, an entity shall first determine whether the promise to grant a licence is *distinct* from other promised goods or services in the contract (i.e. *Step 2 Identify the performance obligations in the contract* under the five-step model). The following diagram summarizes the key requirements:



In the above example, the information provided in the financial statements was insufficient to enable users of the financial statements to understand how the reporting entity had properly applied the above HKFRS 15 guidance based on the nature of the licence services to support the basis for recognizing the licence income over time. Although the amount of licence income recognized by the reporting entity for that year was not significant, the impact on the financial statements was unclear if the revenue should have been recognized at a point in time, instead of over time.

Given licensing arrangements can be different in many ways, a detailed assessment is sometimes required to establish whether revenue arising from a licensing arrangement should be recognized at a point in time or over time. Reporting entities, which earn revenue from grants of licences to customers similar to the example discussed above, are recommended to consider (i) providing more details of the nature of licensing arrangements with customers; (ii) elaborating more in their accounting policy for recognition of revenue from provision of licence services on the different treatments between licence services which are distinct and not distinct from other promised goods or services in the contracts and if the licence services are distinct,

the different accounting treatments for revenue recognition that will be applied based on whether the licence gives a “right to access” or “right to use” the intellectual property; and (iii) disclosing the significant judgement made by management in applying the accounting policy (HKFRS 15 paragraph 110(b)).

Recognition of revenue over time or at a point in time

The last step of the five-step model is “*Step 5 Recognize revenue when (or as) the entity satisfies a performance obligation*”. HKFRS 15 uses a “control” model and revenue is recognized when (or as) control of the goods or services is transferred to the customer. Control may be transferred either at a point in time or over time. If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time (HKFRS 15 paragraphs 31 and 32). The assessment of when control is transferred should be made from the perspective of the customer (HKFRS 15 BC 121).

The financial statements of a reporting entity in the online game industry disclosed that the online games and other premium features in the games purchased by customers using virtual currencies were considered as value-added services rendered over a pre-specified period or throughout the whole game life. According to its disclosed accounting policy, for those online games and other premium features purchased by virtual currencies, the reporting entity recognized the relevant revenue either (1) at a point in time upon consumption or (2) over time ratably based on the practical usage period predetermined in the game. Therefore, based on the disclosures provided, it was reasonable to expect that some revenue of the reporting entity’s online gaming operations were recognized over time and some at a point in time.

However, in the above example, the disaggregated revenue disclosures showed that, apart from the licensing income which was recognized over time, other revenue was recognized at a point in time. The disclosure implied that all revenue from online gaming operations were recognized at a point in time. This raised doubts about whether the reporting entity had properly followed its accounting policy to recognize the different types of revenue from online gaming operations. Therefore, an enquiry letter was issued to ask the auditor to provide more information about the reporting entity’s revenue from online gaming operations and how they were satisfied that the related revenue was appropriately recognized according to the accounting policy.

As stated, if an entity does not transfer control over time, it is presumed that control is transferred at a point in time. Therefore, in Step 5 of the five-step model, an entity shall first assess whether the identified performance obligation is satisfied over time under HKFRS 15. Such assessment should be performed at contract inception.

HKFRS 15 paragraph 35 states that “*An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:*

- (a) *the customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs (see paragraphs B3–B4);*
- (b) *the entity’s performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced (see paragraph B5); or*

(c) *the entity's performance does not create an asset with an alternative use to the entity (see paragraph 36) and the entity has an enforceable right to payment for performance completed to date (see paragraph 37)" (underline added).*

The above requirement results in changes in the assessment as compared to HKAS 18 and HKAS 11 *Construction Contracts*. Under HKFRS 15, the conclusion of whether revenue is recognized over time is reached after evaluation of the above three criteria; contrary to the previous practice (e.g. whether the contract meets the definition of "construction contract" in order to apply the percentage of completion method under HKAS 11).

In the above example, the auditor provided more information in its response about the reporting entity's online gaming operations. It explained that the reporting entity sold two types of virtual items, i.e. consumable virtual items (of which revenue was recognized at a point in time) and durable virtual items (of which revenue was recognized over time). Since there were only sales of consumable virtual items during the year, all revenue was recognized at a point in time (i.e. none "over time"). Due to different nature and bases for revenue recognition, the reporting entity should consider providing more disaggregated revenue information categorized based on major lines/types of online gaming products (HKFRS 15 paragraph B89) in its financial statements.

(iv) Disclosure deficiencies

Much more extensive disclosures, both quantitative and qualitative, are required under HKFRS 15 as compared to the previous revenue standards (e.g. HKAS 18), in order to meet the objective of HKFRS 15 – i.e. to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers (HKFRS 15 paragraph 110).

Most of the financial statements reviewed stated that there were no material impacts resulting from the adoption of HKFRS 15 in 2018. However, as discussed in various parts of this section, the disclosures in various financial statements reviewed were inadequate or insufficient. In some cases, the accounting policies for revenue recognition disclosed were somewhat boilerplate and generic with limited information to enable readers to have a reasonable understanding of how the specific areas in HKFRS 15 that were relevant to the entities were accounted for by the reporting entities. Given HKFRS 15 requires consideration of more aspects of a transaction, deficiencies in disclosures would very often cause doubts about whether HKFRS 15 had been properly considered and followed.

Some other commonly omitted disclosures required by HKFRS 15 are summarized as follows:

- an explanation of the judgements made in applying HKFRS 15 that significantly affects the determination of the timing of satisfaction of performance obligations (HKFRS 15 paragraph 123(a)) and the transaction price and the amounts allocated to performance obligations (HKFRS 15 paragraph 123(b));

- disaggregation of revenue⁹ recognized from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors (HKFRS 15 paragraph 114);
- revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period (HKFRS 15 paragraph 116(b)); and revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (HKFRS 15 paragraph 116(c));
- the aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially unsatisfied) as of the end of the reporting period (HKFRS 15 paragraph 120(a)); and an explanation of when the entity expects to recognize as revenue the amount disclosed in accordance with paragraph 120(a) (HKFRS 15 paragraph 120(b));
- an explanation of how the timing of satisfaction of an entity's performance obligations (see paragraph 119(a)) relates to the typical timing of payment (see paragraph 119(b)) and the effect that those factors have on the contract asset and the contract liability balances (HKFRS 15 paragraph 117);
- an explanation of the significant changes in the contract asset and the contract liability balances during the reporting period (HKFRS 15 paragraph 118); and
- the methods, inputs and assumptions used for determining the transaction price, which includes, but is not limited to, estimating variable consideration (HKFRS 15 paragraph 126(a)); and measuring obligations for returns, refunds and other similar obligations (HKFRS 15 paragraph 126(d)).

HKFRS 9 (2014) and HKFRS 15 are complex financial reporting standards. There are a lot of complexities in the practical application of HKFRS 9 and HKFRS 15 and judgement may be required to determine the appropriate accounting treatment. The above are issues that were identified from our reviews so far and more may be identified in future reviews. We shall continue reviewing the post-implementation of the two standards and sharing with members the application issues identified and provide relevant guidance to members through different channels. Many useful resources are also available on the Institute's website, including a dedicated web page to facilitate members to have a quick access to the relevant resources on all new and major standards. The web page can be accessed at:

<https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/New-and-major-standards/New-and-Major-Standards>

⁹ Some examples are provided in HKFRS 15 to illustrate the requirements in HKFRS 15 on disaggregation of revenue disclosure (Example 41 – IE210 to IE211) and disclosure of the transaction price allocated to the remaining performance obligations (Example 42 to 43 – IE212 to IE221). Members are recommended to refer to those examples for better understanding of the disclosure requirements.

Section II – Significant or common application issues of other financial reporting standards

In this part of the report, we will share with you the issues identified relating to the application of some recurring financial reporting standards, namely HKAS 36 *Impairments of Assets*, HKFRS 3 (Revised) *Business Combinations* and HKFRS 13 *Fair Value Measurement*. A recap of some key requirements are provided in the relevant parts of this section as appropriate.

1. HKAS 36 *Impairment of Assets*

(i) *Impairment of corporate assets*

In regards to the impairment assessment of an asset¹⁰, members should properly follow the relevant requirements set out in HKAS 36 to measure the asset's recoverable amount (based on value in use and/or fair value less costs of disposal¹¹) such that the impairment loss so derived is adequately supported. This year, we focus on discussing a new area – impairment assessment of corporate assets – which had not been covered in detail in previous reports.

HKAS 36 paragraph 22 states that recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit (“CGU”) to which the asset belongs. Examples of assets that inherently do not generate independent cash inflows are goodwill and corporate assets. Given the focus of impairment assessment is often on CGUs and goodwill, the need to consider the implication of corporate assets might easily be overlooked.

HKAS 36 paragraph 6 defines “corporate assets” as “*assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units*” (underline added). Examples of corporate assets are headquarters building, research centre and central IT facilities.

¹⁰ As required by HKAS 36 paragraph 10, intangible assets with indefinite useful lives, intangible assets not yet available for use and goodwill acquired in a business combination must be tested annually to determine whether they are impaired. Other assets (e.g. property, plant and equipment and investments in associates and joint ventures) have to be tested only if there is an indication of impairment (HKAS 36 paragraph 9). However, entities are still required to assess at the end of each reporting period whether there is any indication of impairment. Apart from some specified assets (i.e. intangible assets with indefinite useful lives, intangible assets not yet available for use and goodwill acquired in a business combination), HKAS 36 does not require an entity to make a formal estimate of recoverable amount if no indication of an impairment loss is present (HKAS 36 paragraph 8).

¹¹ The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs of disposal (“FVLCD”) and its value in use (“VIU”). Therefore, an entity may need to determine both FVLCD and VIU in determining the recoverable amount of an asset. However, it is not always necessary to determine both an asset's FVLCD and its VIU. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount (HKAS 36 paragraph 19). An entity may use the asset's VIU as its recoverable amount if there is no basis for making a reliable basis of measuring the FVLCD (HKAS 36 paragraph 20). If there is no reason to believe that an asset's value in use materially exceeds its FVLCD, the asset's FVLCD may be used as its recoverable amount, e.g. in the case for an asset held for disposal (HKAS 36 paragraph 21).

A set of financial statements reviewed showed that at the year end, the reporting entity had significant property, plant and equipment which mainly represented the cost of construction in progress of a research centre and a headquarter in Mainland China. No impairment loss was recognized on these assets. Such fixed assets appeared to have met the definition of “corporate assets” under HKAS 36. However, the reporting entity did not mention in its accounting policy for impairment assessment any reference to corporate assets, e.g. to explain what are considered as corporate assets and how the impairment testing of corporate assets is carried out.

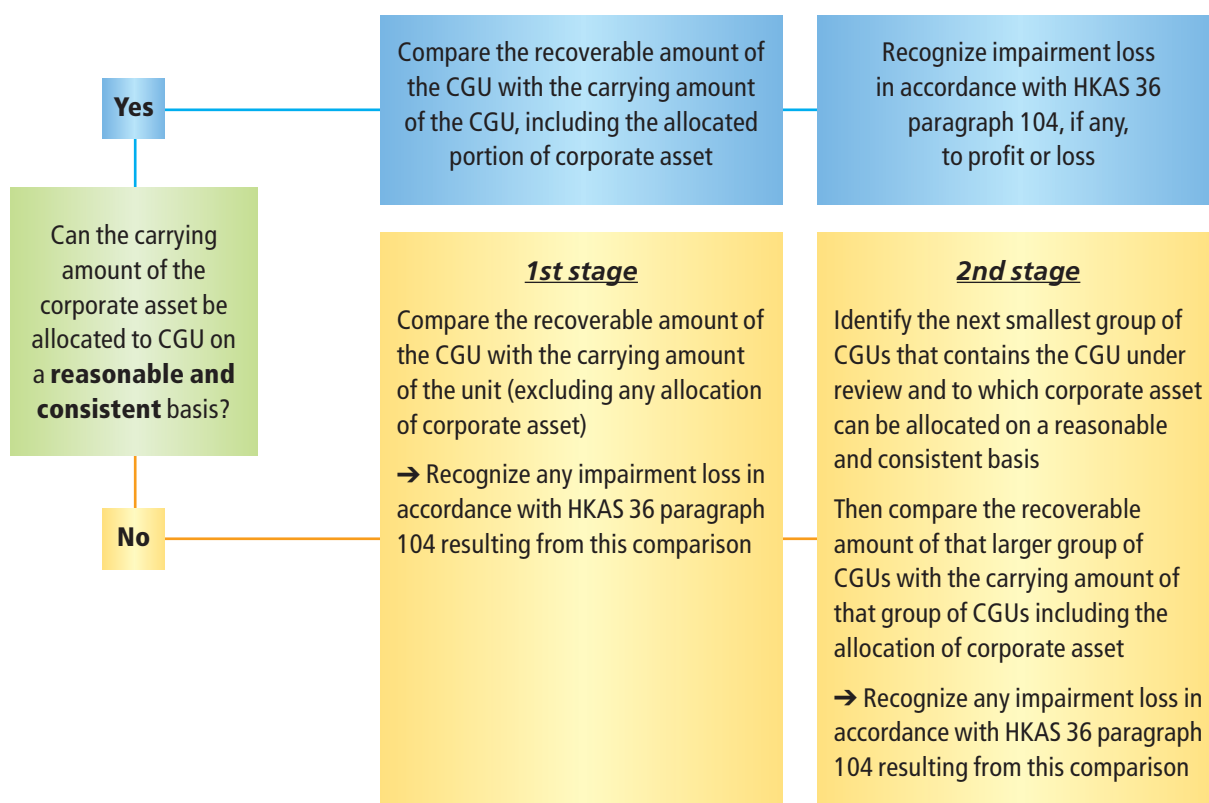
The above reporting entity reported that its only reportable operating segment incurred a significant operating loss for the year. There was however no disclosure to explain whether, in performing the impairment assessment, the reporting entity had followed the requirements of HKAS 36 paragraph 102 to identify the corporate assets that related to a CGU under review and allocate a portion of the carrying amount of the corporate assets to the CGU. This raised questions whether the impairment assessment performed complied with HKAS 36.

HKAS 36 paragraph 102 requires that in testing a CGU for impairment, an entity shall identify all the corporate assets that relate to the CGU under review. The distinctive characteristics of corporate assets are that they do not generate cash inflows independently of other assets or groups of assets and their carrying amount cannot be fully attributed to the CGU under review (HKAS 36 paragraph 100). If there is an indication that a corporate asset may be impaired (e.g. obsolescence of IT facilities), the corporate asset must be tested as part of a CGU as it does not generate independent cash inflows. It is also possible that the indication of impairment may not specific to a corporate asset but due to the CGU to which the corporate asset relates (e.g. the example discussed above). In either situation, proper impairment assessment should be carried out based on the guidance in HKAS 36 as further explained below.

HKAS 36 paragraph 102 sets out an approach to allocation of corporate assets, which includes a 2-stage approach¹² if the allocation cannot be performed on a reasonable and consistent basis.

¹² This requirement applies when a portion of a corporate asset cannot be allocated to a CGU on a reasonable and consistent basis. The first stage and the second stage can be viewed as “bottom-up” test and “top-down” test, respectively.

Allocation of corporate asset



Example 8 of HKAS 36 provides an illustrative example of how to deal with the (1) identification of corporate assets; (2) allocation of corporate assets; and (3) determination of recoverable amount and calculation of impairment losses. Members are encouraged to study that Example to gain a better understanding of the application of HKAS 36 paragraph 102. That Example illustrates how the carrying amount of the headquarters building is allocated to respective CGUs and the allocation is weighted based on the estimated remaining useful lives of the CGUs. There is no specific guidance in HKAS 36 on what is considered to be a “reasonable and consistent” basis. Accordingly, other appropriate bases may also be used depending on the entity’s structure, nature of assets and judgement. Example 8 also illustrates how to deal with the situation where there is more than one corporate asset and includes a research centre that could not be allocated on a reasonable and consistent basis.

An important point to note is that entities should ensure that the carrying amounts of the assets of all CGUs in a group should add up to the aggregate carrying amount of that group’s assets. No assets that are within the scope of HKAS 36 should be excluded from the impairment review.

There might be situations where a reporting entity has both corporate assets and goodwill. HKAS 36 provides respective guidance on impairment testing of corporate assets and goodwill but not guidance on how the testing should be carried out when both corporate assets and goodwill are present. Members should develop an appropriate accounting policy in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* which is consistent with the relevant requirements of impairment testing of goodwill and corporate assets under those situations.

(ii) Other issues identified relating to HKAS 36

Indicators for impairment

As for previous years' reviews, instances were still found which showed the presence of impairment indicators but no impairment loss was recognized by the reporting entities. This raised concerns whether work to assess possible impairment of assets had been performed. Entities should consider, as a minimum, whether the indications set out in HKAS 36 paragraph 12 exist in assessing whether there is any indication that an asset may be impaired. Both external and internal sources of information should be considered. For example, an economic downturn, introduction of a strong competitor and operating at a loss, etc. could be relevant factors to be considered in the assessment depending on an entity's own circumstances.

Determination of discount rate

Another issue commonly identified is on the discount rate applied to the cash flow projections for impairment assessments. For example, there were two cases where the reporting entities used a much lower discount rate for the calculation of the value in use as compared to last year but no justification was disclosed. The discount rate used can significantly affect the results of the impairment assessment. An enquiry will likely be raised if we consider the potential financial impact may be significant.

Members are reminded that, to avoid double counting, the discount rate used to measure an asset's value in use should not reflect those risks for which the future cash flow estimates have been adjusted (HKAS 36 paragraph 56). Appendix A to HKAS 36 provides further guidance.

Disclosure deficiencies

Similar disclosure deficiencies as found in prior years' reviews continued to be identified: e.g. no disclosure of the discount rate (HKAS 36 paragraph 134(d)(v)) and growth rate (HKAS 36 paragraph 134(d)(iv)) used in the impairment assessment of goodwill where the recoverable amount of the CGU to which the goodwill was allocated was determined based on value in use; no disclosure of information required under HKAS 36 paragraphs 134(f) and 135(e) in situations where a reasonably possible change in a key assumption on which management had based its determination of a CGU's (group of CGU's) recoverable amount would cause the CGU's (group of CGU's) carrying amount to exceed its recoverable amount; no disclosure of the events and circumstances that led to the recognition or reversal of the impairment loss (HKAS 36 paragraph 130(a)); and no disclosure of a description of the CGU for which an impairment loss has been recognized (HKAS 36 paragraph 130(d)(i)).

2. HKFRS 3 (Revised) Business Combinations

HKFRS 3 (Revised) applies to a transaction that meets the definition of a business combination. In past reviews, common issues identified included those concerning: (1) identification of a business combination (e.g. whether the acquisition transaction constituted a business combination under HKFRS 3 (Revised) or an acquisition of assets); and (2) purchase price allocation (e.g. whether all the identifiable assets acquired and liabilities assumed had been properly identified and measured at acquisition-date fair value). These issues were still identified in the year under review. This year, we share another application issue under HKFRS 3 (Revised).

(i) Business combinations under common control

Most business combinations are within the scope of HKFRS 3 (Revised). However, business combinations under common control (“BCUCC”) are specifically scoped out from HKFRS 3 (Revised). The following sets out an example encountered in our reviews that raised questions about the appropriateness of the accounting for a BCUCC.



A reporting entity acquired 100% equity interest in another company during the year and accounted for such acquisition using a pooling of interest method as the reporting entity and the legal acquiree were under common control of another entity before and after the acquisition. The financial statements disclosed that the reporting entity elected to not restate the financial statements for periods prior to the completion of the BCUCC. Accordingly, the consolidated statement of profit or loss and the consolidated statement of other comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows of the reporting entity included the results and cash flows of the acquired business only from the date when the reporting entity obtained control of the acquired business. Therefore, there were questions whether the aforesaid accounting treatment of the BCUCC was appropriate.

As there is currently no guidance in HKFRSs on the accounting for BCUCC, management should apply judgement to develop an appropriate accounting policy in accordance with HKAS 8.

HKAS 8 paragraphs 10 to 12 requires that, in the absence of a HKFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is relevant to the economic decision-making needs of users and reliable. In making the judgement in developing and applying the accounting policy, HKAS 8 paragraph 12 further states that management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards.

Accounting Guideline 5 *Merger Accounting for Common Control Combinations* (“AG 5”) sets out the basic principles and procedures of merger accounting when recognizing a common control combination. AG 5 paragraph 7 states that *“In applying merger accounting, financial statement items of the combining entities or businesses for the reporting period in which the common control combination occurs, and for any comparative periods disclosed, are included in the consolidated financial statements of the combined entity as if the combination had occurred from the date when the combining entities or businesses first came under the control of the controlling party or parties”* (underline added).

Preface to Hong Kong Financial Reporting Standards (“Preface”) paragraph 35 states that “Accounting Guidelines have effect as guidance statements and indicators of best practice. They are persuasive in intent. Unlike HKFRSs, Accounting Guidelines are not mandatory on members of the HKICPA but are consistent with the purpose of HKFRSs in that they help define accounting practice in the particular area or sector to which they refer. Therefore, they should normally be followed and members of the HKICPA should be prepared to explain departures if called upon to do so” (underline added).

Given that the reporting entity disclosed that the principle of merger accounting was applied and the consolidated financial statements were prepared in accordance with HKFRSs and the accounting principles generally accepted in Hong Kong, it is reasonable to expect that AG 5 should have been applied in accounting for the BCUCC. However, as the reporting entity elected not to restate the financial statements for periods prior to the completion date of the BCUCC, it showed that AG 5 had not been followed. Therefore, the auditor was asked to explain how the reporting entity applied HKAS 8 to develop the accounting policy for BCUCC and how they were satisfied with the reporting entity’s accounting policy.

In correspondence with the auditor, we were advised that the reporting entity had considered the hierarchy set out in HKAS 8 paragraphs 10 to 12 to establish an accounting policy for the BCUCC with reference to the generally accepted accounting standards in the United States of America (“US GAAP”) Accounting Standards Codification 805 *Business Combinations* and AG 5. The auditor’s response further provided the management’s view on non-restatement of financial information prior to the completion date of the BCUCC. In its view, the scope of HKFRS 10 *Consolidated Financial Statements* applies to all consolidated financial statements without any scope exclusion for a BCUCC. It considered that the fact that the BCUCC entered into by the reporting entity which was scoped out from HKFRS 3 (Revised) was not relevant when considering the requirements of HKFRS 10. Under HKFRS 10, an entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control.

According to the research¹³ conducted by the Standard Setting Department of the Institute on reporting of BCUCC in Hong Kong, the majority of the companies that reported under the HKFRS framework stated explicitly that they applied AG 5 to account for BCUCC. The above example, however, showed variations in practice in respect of the application of the pooling of interest method (other terms such as “merger accounting”, “predecessor value method”, “carryover basis” sometimes are used).

¹³ P.12 of the research report states that “A majority of the companies that reported under the HKFRS framework stated explicitly that they applied the predecessor method under AG 5 to account for common control combinations. Most companies that reported under the IFRS framework did not specify whether AG 5 or another predecessor method was applied, but explained in the accounting policy that the common control combinations were accounted for using the existing carrying values of the transferred businesses. Companies that reported under the CASBE framework specified that they applied the predecessor method under CASBE”. For a full version of the research report, please visit: https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/Standards-and-regulation/SSD/07_Major-projects/BCUCC/BCUCC19.pdf

The International Accounting Standards Board (“IASB”) noted that companies account for BCUCC in different ways, which make it difficult for investors and regulators to compare the effects of those transactions on companies’ financial positions and performance. In this regard, the IASB is carrying out a project on BCUCC and expects to publish a discussion paper in the first half of 2020. Members may refer to the links below to obtain information of the latest development of the IASB project on BCUCC and the activities undertaken by the Institute to drive global discussions on BCUCC and to provide input to the IASB:

- <https://www.ifrs.org/projects/work-plan/business-combinations-under-common-control/#current-stage>
- <https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/Major-projects/Business-Combinations-under-Common-Control>

Therefore, prior to the issuance of the specific guidance on the accounting for BCUCC by the IASB, reporting entities still need to apply their judgement to develop an accounting policy for BCUCC that provides relevant and reliable information in accordance with HKAS 8. Although AG 5 is not mandatory, it is persuasive in intent. Therefore, in cases where AG 5 is not applied to account for a BCUCC, it would be useful to make appropriate disclosures in the financial statements such that readers would appreciate the main factors considered or judgement made in coming to an accounting treatment that differs from AG 5. Members should also be prepared to explain the departures from the relevant guidelines of AG 5 if called upon to do so.

It is noteworthy that HKFRS 3 excludes BCUCC from its scope only if the common control is “not transitory” (HKFRS 3 (Revised) paragraph B1). This prevents entities to avoid acquisition accounting simply by structuring the transactions to include a brief common control phase. “Transitory” is not defined in HKFRS 3 (Revised). Judgement may be required in assessing whether the common control is transitory or not.

(ii) Disclosure deficiencies

In our 2019 reviews, we continued to identify disclosure omissions in relation to business combinations. The more common examples are omissions to disclose (1) the circumstances that led to the recognition of goodwill in the business combination; and (2) financial information on the acquisitions after the year end (HKFRS 3 (Revised) paragraphs 59(b) and B64 to B66).

3. HKFRS 13 Fair Value Measurement

HKFRS 13 is widely applied and used in conjunction with other HKFRSs that require or permit fair value measurements. HKFRS 13 defines “fair value”, sets out a single HKFRS framework for measuring fair value and prescribes disclosures about fair value measurements (HKFRS 13 paragraph 1).

(i) Measurement issue

HKFRS 13 increases comparability in fair value measurements through establishing a “fair value hierarchy”. The hierarchy gives the highest priority to (unadjusted) quoted prices in active markets for identical assets or liabilities (Level 1 inputs) and the lowest priority to unobservable inputs (Level 3 inputs) (HKFRS 13 paragraph 72). This is because Level 1 inputs generally provide the most reliable estimate of fair value. Issues often

arise in respect of the fair value measurement of unlisted investments as the valuation inputs are often unobservable and significant judgement and estimation may also be needed in determining and applying a valuation technique. The following sets out an example that we came across in our 2019 reviews relating to fair value measurement of unlisted investments.

A reporting entity, which was assessed to be an investment entity under HKFRS 10, invested in some unlisted non-voting preference shares and unlisted partnership interests which were accounted for as financial assets at FVTPL. The financial statements disclosed that the fair value measurements of these investments were measured based on “share of the net assets” of the investments.

HKFRS 13 paragraph BC238 (a) states that, *“There are different accounting requirements in IFRSs and US GAAP for measuring the fair value of investments in investment companies. Topic 946 Financial Services — Investment Companies in US GAAP requires an investment company to recognise its underlying investments at fair value at each reporting period. Topic 820 provides a practical expedient that permits an entity with an investment in an investment company to use as a measure of fair value in specific circumstances the reported net asset value without adjustment. IFRS 10 Consolidated Financial Statements requires an investment company to consolidate its controlled underlying investments. Because IFRSs do not have accounting requirements that are specific to investment companies, the IASB decided that it would be difficult to identify when such a practical expedient could be applied given the different practices for calculating net asset values in jurisdictions around the world. For example, investment companies may report in accordance with national GAAP, which may have recognition and measurement requirements that differ from those in IFRSs (ie the underlying investments might not be measured at fair value, or they might be measured at fair value in accordance with national GAAP, not IFRSs). The boards are reviewing the accounting for investment companies as part of a separate project”* (underline added)¹⁴.

The above information shows that, although US GAAP provides a practical expedient to measure the fair value of certain investments in investment companies using net asset value (without adjustment), HKFRS 13 does not provide a similar practical expedient treatment. Therefore, HKFRS preparers cannot presume that the net asset value is the same as the fair value as measured in accordance with HKFRS 13. Accordingly, before using the net asset value of an unlisted investee as a basis for determining its fair value, the reporting entity should first carefully assess whether the underlying calculation of how the net asset value of an unlisted investee has met the definition of fair value under HKFRS 13 paragraph 9 (i.e. the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date) and make appropriate disclosures to enable users of financial statements to understand its assessment. In addition, entities should categorize such investments within the fair value hierarchy and comply with relevant disclosure requirements under HKFRS 13.

¹⁴ A footnote was added to HKFRS 13 paragraph BC238(a) confirming that at its meeting in October 2012, the IASB reconsidered providing a net asset value practical expedient, but decided against this because there are different calculation methods in different jurisdictions.

(ii) Disclosure deficiencies

HKFRS 13 disclosure requirements are separated into two main categories, namely (1) disclosures for assets and liabilities measured at fair value in the statement of financial position after initial recognition; and (2) disclosures for fair value measurements of assets and liabilities that are required or permitted to be disclosed by other HKFRS, which are not included in the statement of financial position. The disclosure requirements relating to (1) are more extensive than (2). There are also different disclosure requirements depending on whether a fair value measurement is recurring or non-recurring.

The disclosures in some financial statements did not specify whether the fair value measurement on some assets was recurring or non-recurring. Some disclosures of how the fair value of the relevant asset was determined were also insufficient, e.g. the disclosures only generally stated that the valuation was based on “some recent market transactions”. Entities should consider to provide both qualitative and quantitative information in order to enable users of financial statements to better understand the fair value measurement.

In respect of the disclosure category (1) above, more extensive disclosures are required for Level 3 fair value measurements than Level 1 and Level 2 and those requirements are set out in HKFRS 13 paragraph 93. Based on our 2019 reviews, the following disclosures required by HKFRS 13 paragraph 93 were often missing:

- for fair value measurements categorized within Level 3 of the fair value hierarchy,
 - (i) a reconciliation from the opening balances to the closing balances of assets and liabilities measured at fair value (e.g. financial assets measured at fair value through other comprehensive income and financial assets measured at fair value through profit or loss), disclosing separately changes during the period attributable to the items set out in HKFRS 13 paragraph 93(e);
 - (ii) quantitative information about the significant unobservable inputs used in the fair value measurement and a description of the valuation technique(s) (HKFRS 13 paragraph 93(d)); and
 - (ii) for recurring fair value measurements, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement (HKFRS 13 paragraph 93(h)(i)).

Please refer to our previous QAD annual reports through the link below where more discussions about issues on impairment assessments, business combinations and fair value measurement can be found:

<https://www.hkicpa.org.hk/en/Standards-and-regulation/Quality-assurance/Professional-standards-monitoring/Publications-and-Reference-Materials>

Section III – Common disclosure and presentation deficiencies

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that users make on the basis of the financial statements (HKAS 1 (Revised) paragraph 7, effective from 1 January 2020). Members should ensure that material information as required by applicable financial reporting standards is disclosed in the financial statements.



Save for the disclosure and presentation deficiencies discussed in Section I and Section II of this report, the following is an overview of some other more common disclosure omissions identified in our 2019 reviews.

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

- a description of the nature and purpose of each reserve within equity (HKAS 1 (Revised) paragraph 79(b));
- summary quantitative data about what an entity manages as capital (HKAS 1 (Revised) paragraph 135(b));
- the amount expected to be recovered or settled after more than 12 months for each asset and liability line item that combines amounts expected to be recovered or settled within 12 months after the reporting period and those expected to be recovered or settled more than 12 months after the reporting period (HKAS 1 (Revised) paragraph 61);
- the nature of the major components of significant balances such as other receivables, deposits and other payables and sub-classifications of the line items presented, classified in a manner appropriate to the entity's operation (HKAS 1 (Revised) paragraphs 17(c), 77 and 112(c));
- the accounting policy comprising the measurement basis used to account for significant account balances e.g. research and development cost and equity instrument (HKFRS 7 paragraph 21 / HKAS 1 paragraph 117); and
- the respective carrying amount of the assets at the end of the reporting period that involve significant estimation uncertainty (HKAS 1 (Revised) paragraph 125(b)).

In addition, we continued to find instances where the reporting entities presented dividends paid in their consolidated income statement. This is not permitted as HKAS 1 (Revised) requires the presentation of dividends recognized as distributions to owners and related amounts per share in the statement of changes in equity or in the notes. The requirement is to ensure that owner changes in equity (in this case, distributions to owners in the form of dividends) are presented separately from non-owner changes in equity (presented in the statement of comprehensive income) (HKAS 1 (Revised) paragraphs IN6, IN9, 107 and BC75).

2. HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

- the title, the nature and expected impact of all the new HKFRS that have been issued but not yet effective and the date by which the application of the HKFRS is required (HKAS 8 paragraphs 30 to 31).

3. HKFRS 7 Financial Instruments: Disclosures

- for each class of the financial assets and financial liabilities, the fair value of that class of assets and liabilities that is disclosed in a way that permits it to be compared with its carrying amount, except those set out in HKFRS 7 paragraph 29 (HKFRS 7 paragraph 25); and
- the terms and conditions relating to financial assets pledged as collateral for liabilities or contingent liabilities (HKFRS 7 paragraph 14(b)).

Communication with members

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

- The QAD hosted two forums, one in August and one in September 2019, which drew a combined total of around 550 attendees. The forums covered common findings from practice reviews and recommended actions that could be taken by practices to enhance audit quality. A webcast of the forum has been available on the Institute's website from November 2019.
- The QAD team was invited by the Society of Chinese Accountants and Auditors to present in a seminar in November 2019 on the same topics covered in the Quality Assurance Forum. The seminar attracted over 200 attendees.
- The QAD team participated in the practice review session of the 2019 SMP Symposium in November 2019 which attracted approximately 350 attendees.
- The QAD issued a number of publications including an annual report and alerts covering topics such as initiatives and measures to strengthen actions to deal with non-compliance; valuation on acquisition; practice review scope and selection after audit regulatory reform.
- The QAD developed and posted on the Institute's website a number of frequently asked questions concerning AML / CTF compliance.

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

Members of the Regulatory Oversight Board in 2019

Name	Position	Company
Ms. HO, Shuk Yee, Susie (Appointed 28 January 2019)	Chairman	
Mr. CHAN, Kam Wing, Clement	Member	BDO Limited
Ms. CHAN, Mei Bo, Mabel (Appointed 28 January 2019)	Member	Grant Thornton (Hong Kong) Limited
Mr. CHUI, Yik Chiu, Vincent (Appointed 28 January 2019)	Member	Morgan Stanley Asia Ltd
Ms. CHUNG, Lai Ling	Member	Gov't of HKSAR
Mr. HO, Chiu Ping, Dennis	Member	PricewaterhouseCoopers
Mr. KENNEDY, Paul Michael (Appointed 28 January 2019)	Member	Dah Sing Financial Holdings Limited
Ms. LAU, Wai Yin, Susanna	Member	Securities and Future Commission
Mr. POGSON, Timothy Keith	Member	Ernst & Young
Mr. YIH, Lai Tak, Dieter, JP	Member	Kwok Yih & Chan

Members of the Practice Review Committee in 2019

Name	Position	Company
Ms. YAM, Hoi Yin, Cecilia	Chairman	BDO Limited
Mr. HEBDITCH, Paul Donald	Deputy Chairman	Ernst & Young
Mr. BROADLEY, Derek Thomas	Member	Deloitte Touche Tohmatsu
Mr. CHAN, Ho Yin, Graham	Member	Graham H.Y. Chan & Co.
Mr. CHAN, Tze Kit	Member	Grant Thornton Hong Kong Limited
Mr. CHUI Cheuk Yin, Bruce (Appointed 28 January 2019)	Member	Bruce C.Y. Chui & Co.
Mr. KWOK, Kin Leung	Member	HLB Hodgson Impey Cheng Limited
Mr. LIU, Eugene	Member	RSM Hong Kong / RSM Nelson Wheeler
Mr. LO, Charbon	Member	Crowe (HK) CPA Limited
Mr. NG, Kam Wah, Webster	Member	Webster Ng & Co.
Ms. NG, Shun Yin	Member	KPMG
Mr. PANG, Wai Hang	Member	SHINEWING (HK) CPA Limited
Ms. TSUI, Maria Yuk Hung	Member	PricewaterhouseCoopers
Mr. WONG, Chun Bong (Appointed 28 January 2019)	Member	C.B. Wong & Co

Members of the Professional Standards Monitoring Expert Panel in 2019

Name	Position	Company
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Ms. HSIANG, Yuet Ming	Member	BDO Limited
Mr. KWONG, Kam Wing, Kelvin	Member	Grant Thornton Hong Kong Limited
Mr. LAI, Tak Shing, Jonathan	Member	HLB Hodgson Impey Cheng Limited
Mr. LEE, Chi Man	Member	Deloitte Touche Tohmatsu
Ms. MORLEY, Catherine Susanna	Member	KPMG
Mr. ONG, Wei Dong	Member	Hong Kong Exchanges and Clearing Limited
Mr. PANG, Wai Hang	Member	SHINEWING (HK) CPA Limited
Ms. SO, Hung, Shelley (Appointed 28 January 2019)	Member	PricewaterhouseCoopers
Mr. STEVENSON, James Gary	Member	RSM Hong Kong

Independent Reviewers of the Professional Standards Monitoring Programme in 2019

Company

BDO Limited

Deloitte Touche Tohmatsu

Ernst & Young

Grant Thornton Hong Kong Limited

HLB Hodgson Impey Cheng Limited

KPMG

PricewaterhouseCoopers

RSM Hong Kong

SHINEWING (HK) CPA Limited

ZHONGHUI ANDA CPA Limited

This Annual Report is intended for general guidance only. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this Annual Report can be accepted by the Hong Kong Institute of Certified Public Accountants.

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