
QUALITY ASSURANCE



Driving Audit Quality 2018 Annual Report



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

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Foreword

I am pleased to present to you our 2018 quality assurance report which sets out our work achievements and common findings identified from our practice review and professional standards monitoring programmes in 2018.

In 2018, we carried out more practice reviews than in 2017. While this demonstrates the dedication and effectiveness of our staff, we did not carry out as many as we had hoped in order to meet our original three-year plan to shorten the practice review cycle for practices without listed clients to 6 years. However, the goal remains, and we intend to achieve it as soon as our resources permit.

You will see from this report that the 2018 practice review outcomes have slightly deteriorated compared to those for 2017. The percentage of complaint cases increased, but remained at below 5 percent. In total nine cases proceeded to complaints. Seven cases involved significant "Top 5" findings (defined on page 11) and serious non-compliance with professional standards and issues in professional conduct, including creating working papers in reaction to practice review and issuing a compliance report without carrying out any work; and two cases concerned uncooperative practices. In November 2018, we issued an alert (Alert No. 27) drawing members' attention to the noticeable trend that a practice review complaint would likely result in a cancellation of the practising certificate of the respondent. In order to ensure their practice review will be completed smoothly, practice units should make quality and compliance a prime concern in their audit work and be cooperative in the practice review processes.

In October 2018, we issued an alert (Alert No. 26) announcing the launch of an anti-money laundering ("AML") monitoring programme within our practice review. Since then, we have included an AML review in our practice review visits and are building up resources to enable us to extend our AML reviews to cover all practice units, including those previously exempted from practice reviews because of non-engagements in audit and assurance work. We expect that all practice units should now be aware of their AML compliance responsibilities and be ready to demonstrate compliance during our AML review visits.

As in previous years, we again referred a few cross-border engagements to the Mainland's Ministry of Finance ("MoF") for review. We are appreciative of the support that the MoF has given us and are in the process of developing further cooperation arrangements with the MoF to help us to gain direct access to working papers of certain cross-border engagements.

2018 was a relatively quiet year for our professional standards monitoring programme. Although two major standards on revenue and financial instruments have been issued and preparers should have taken steps to assess the initial application impact, these standards only took effect for 2018 and subsequent years' financial statements. Based on our reviews, the impact disclosures were generally not specific enough to the circumstances of the entity and many included comments that the impact would be immaterial even though the approaches required by these new standards are substantially different from those under the old standards. We expect to see entities making more extensive transitional disclosures in their 2018 financial statements and we will therefore make those transitional disclosures a review focus for 2019.

The Financial Reporting Council (Amendment) Bill 2018 was passed in January 2019 but the effective date of the Bill is still to be gazetted. We will liaise with the Financial Reporting Council ("FRC") about the transitional arrangements for the transfer of practice review responsibilities for listed engagements and make appropriate announcements in due course. We will continue to visit all active practice units although our focus will change to regulation of non-listed audits and AML compliance monitoring. The Institute will continue to have an important role to play in ensuring the quality of services provided by our members.

Last but not least, I would like to thank members and practice units for their support and cooperation in our quality assurance programmes. This year, I hope to see more efforts being made by members and practice units so that our review outcomes would once again improve.

Elsa Ho
Director, Quality Assurance
March 2019

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, that engage in the provision of audit and other related assurance services. The Professional Accountants Ordinance (“PAO”) has empowered the Institute to carry out practice review since 1992. The approach to practice review was revised in 2006 to bring it up to international standards and it is regularly amended to maintain best practice.

With effect from 1 March 2018, the amended Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (“AMLO”) extended the scope of the legislation to cover designated non-financial businesses and professions, including accountants. The Institute, being the regulator of the accounting profession as detailed under the AMLO, is required to assume the responsibilities for monitoring of AML compliance by member practices. Since October 2018, the Institute has included an AML monitoring programme within its practice review programme to monitor the level of compliance of the Institute’s practice units with the Guidelines on Anti-Money Laundering and Counter-Terrorist Financing for Professional Accountants (“AML Guidelines”).

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

The practice review process 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
- Review compliance with AML Guidelines and review selected transactions (with effect from October 2018)
- 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

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. The frequency of reviews of each type of practices is set out below:

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

Note:

1. This recognizes the significance of listed and other public interest entities in Big 4 client portfolios.
2. Practices with 20 or more listed clients will receive an interim review in addition to a full review every three years.
3. The three-year review cycle is in line with international best practice. In order to address concerns over the quality of audits of listed companies by smaller practices, the selection approach has the following additional elements to increase the frequency of practice reviews of practices with less than 20 listed clients (“relevant practices”):
 - a) Relevant practices that take on their first listed audit client will receive a practice review within a year of the date of the first audit report issued on that listed client.
 - b) Relevant practices that have more than one listed engagement and have been the subject of a referral to the FRC by the PRC or a complaint raised by the PRC or the FRC will receive an interim review within the next normal three year cycle.
 - c) Relevant practices that have significant or regular changes in the number of listed engagements will receive an interim review within the normal three year cycle.
4. Practices with other public interest clients, for example, banks, insurance companies, securities brokers, insurance brokers are given priority for reviews. A number of practices are selected for reviews on a random basis to ensure that all practices will have a chance of being selected. Practices with few audit clients and without any predetermined risk factors (“small practices”) are selected for desktop reviews. The Institute has plans to introduce a six-year review cycle for practices without listed clients within the next few years to improve the effectiveness of the practice review system and to benchmark to the practice used by many regulators worldwide.
5. As from October 2018, all practices, unless they are dormant, will be liable to receive an AML monitoring review. A practice will be prioritised for an AML monitoring review if certain risk factors are identified. In order to make best use of resources and to cause less disturbance to practices, the AML monitoring review will be covered within the practice review visits whenever practicable.

The scope of each review includes obtaining an understanding of the practice’s system of quality control, assessing compliance with HKSQC1 “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.

From October 2018, an AML monitoring review is included within a practice review whenever practicable. When it is not practicable to include an AML monitoring review in a practice review visit, e.g. for a practice that does not engage in the provision of audit and other selected assurance services, a separate AML monitoring review will be arranged. An AML monitoring review will include a review of the practice's policies and procedures and a selection of transactions to assess compliance with the AML Guidelines.

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:

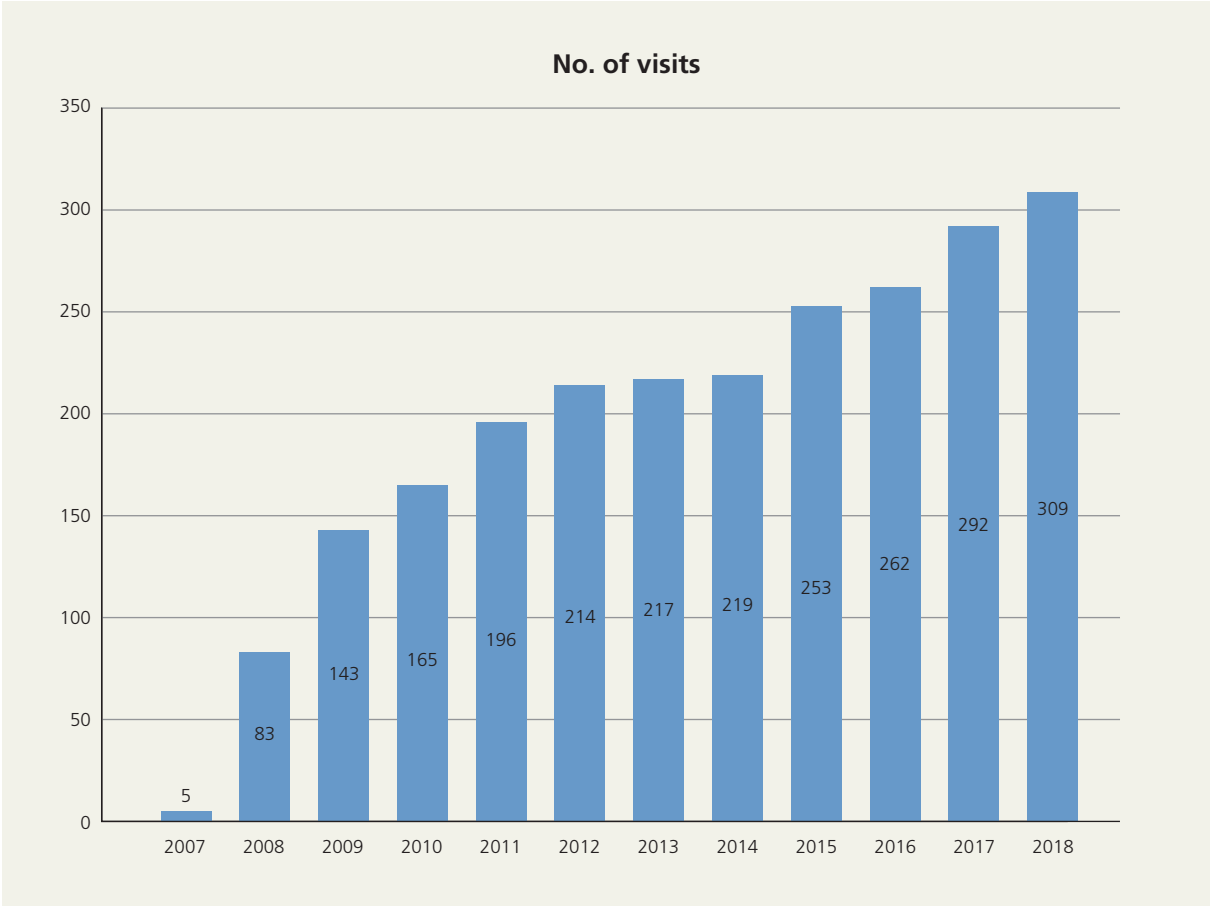
- conclude a practice review with no follow up action required ("direct closed");
- make recommendations and specific requests to a practice, e.g. submission of a status report, to ensure appropriate follow up action is taken to address weaknesses and shortcomings ("required follow up action");
- instruct 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 reviews carried out each year has increased from 83 in 2008 to 309 in 2018.



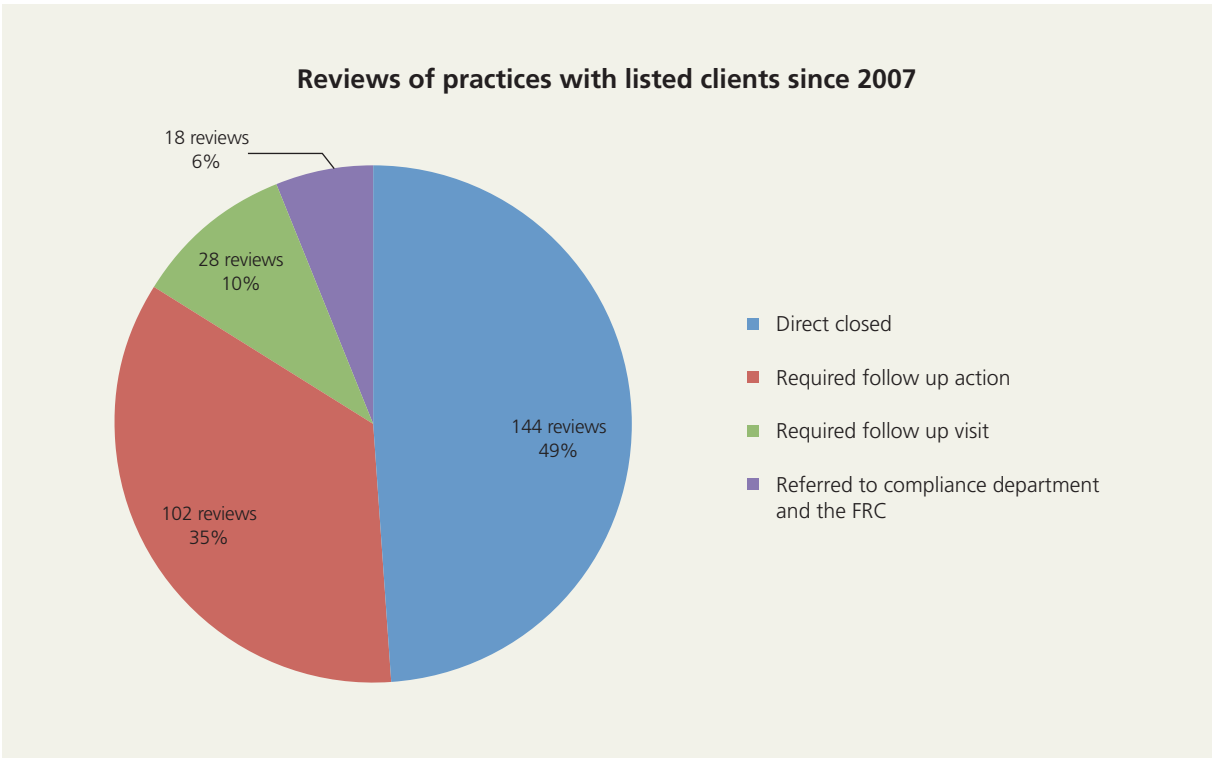
Reviews of practices with listed clients since 2007

In 2018, the QAD carried out 25 visits to practices with listed clients. We referred five cross border engagements to the MoF in Mainland China for review. The Institute will continue to work with the MoF to enhance cooperation and coordination of review work on cross border engagements.

Since the launch of the revised practice review programme in 2007 up to December 2018, the QAD has performed 292 reviews of practices with listed clients covering 103 individual practices. For practices with listed clients where significant findings were identified, the PRC directed the QAD to conduct follow up actions or visits to ensure that findings had been properly addressed. The PRC has a policy to consider referral of significant findings identified in an audit engagement of a listed client to the FRC for further investigation or raising a direct complaint if there is sufficient evidence to support a significant audit failure. If the PRC decided to raise a direct complaint, the FRC will be notified of the decision.

Up to December 2018, a total of fifteen cases from reviews of twelve practices with listed clients have been referred to the FRC for investigation. Seven investigations resulted in complaints and disciplinary actions against the relevant practices as a result of serious non-compliance with professional standards and serious technical failings. Five cases are still under investigation by the FRC. The remaining three cases are under consideration by the Institute for further regulatory action following the FRC investigations.

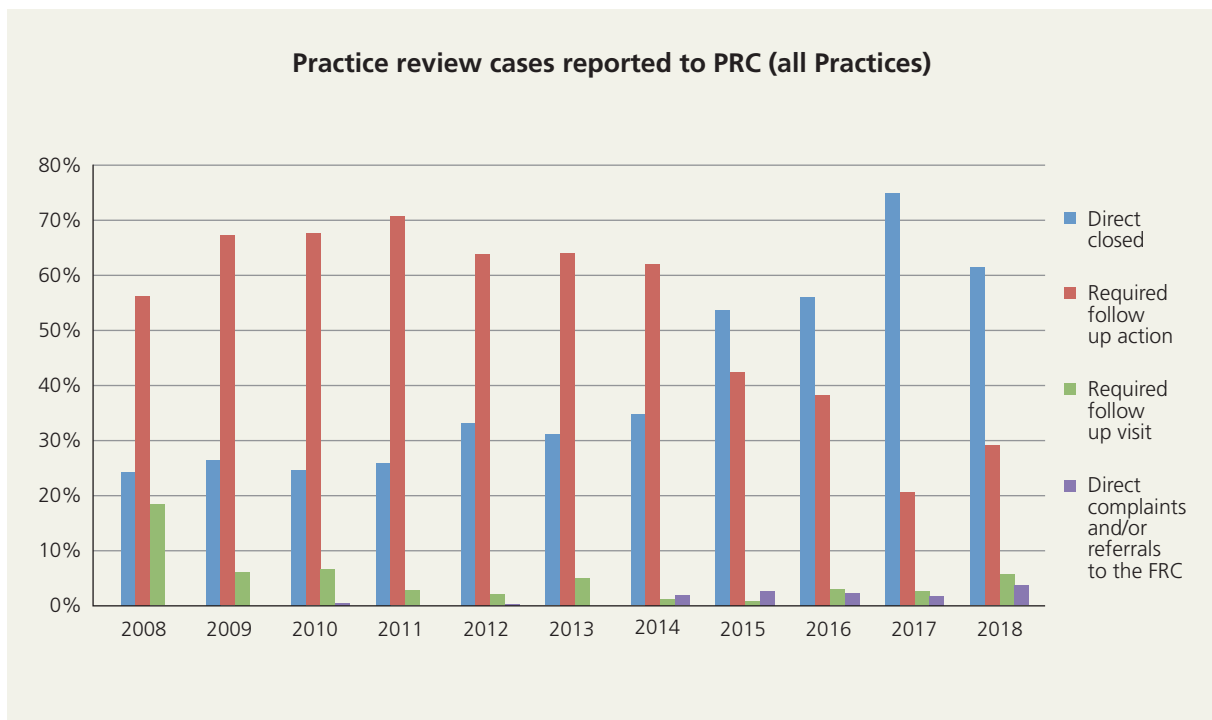
In addition, four direct complaints against practices with listed clients were raised by the PRC up to December 2018. Two complaints were concluded with results of disciplinary actions against the relevant practitioners, one proceeded to disciplinary proceedings, and another is being handled by the Institute’s compliance department.



Work progress in 2018

The PRC met on ten occasions in 2018 and considered 270 practice review reports. The PRC concluded that 161 initial visits should be closed without requiring any follow up actions. For 77 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. Sixteen reviews required a follow up visit to assess the effectiveness of remedial actions taken. Nine reviews including three practices with listed clients proceeded to complaints and / or referrals to the FRC.

Seven follow up visits were reported to the PRC in 2018. Three follow up visits were closed on the basis that adequate remedial actions had been taken, two required further follow up actions, one required another follow up visit and, and one proceeded to a complaint.



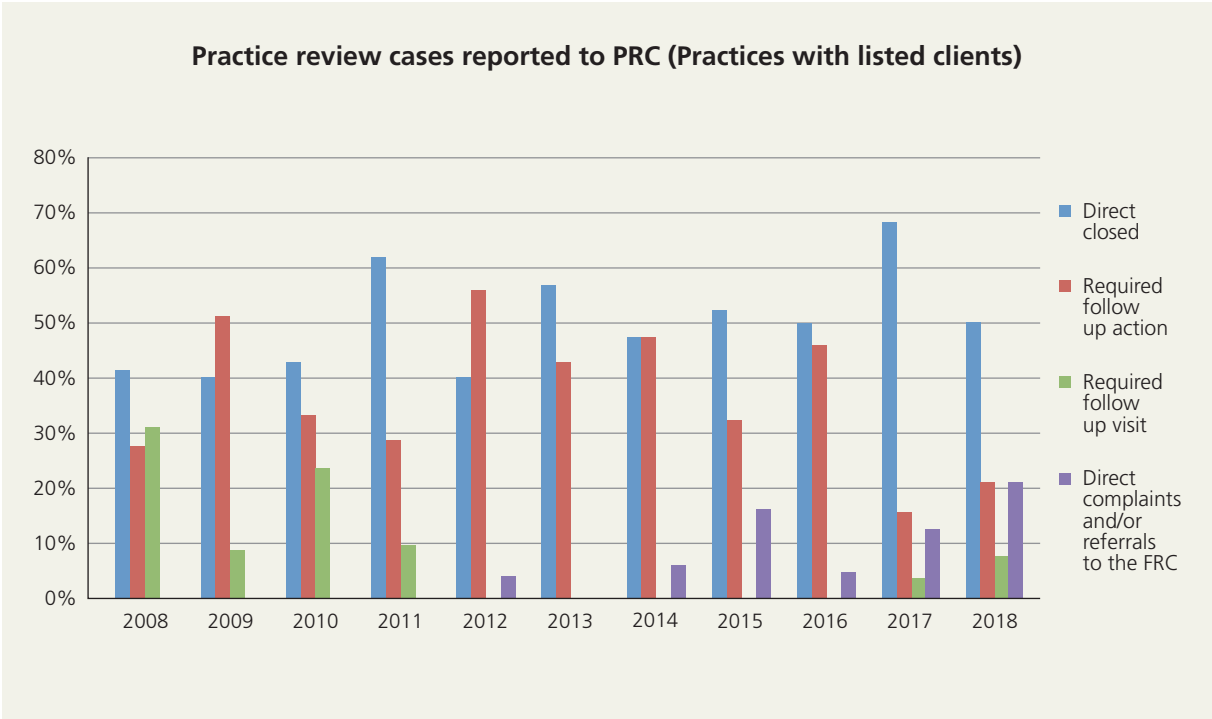
Practices with listed clients

For practices with listed clients, directly closed reviews have decreased from 69% in 2017 to 50% in 2018 while reviews requiring follow up action have increased from 16% in 2017 to 21% in 2018. The review outcomes indicate the need for improvement in audit quality.

In 2018, we also encountered specific cases that required us to take more robust actions. The PRC directed one follow up visit and one practice was the subject of a complaint raised by the PRC due to significant deficiencies, including failings to exercise adequate professional skepticism, in the audit of a listed client.

In addition, two listed entity audits of two other practices were referred to the FRC. In one case, the auditor failed to identify the accounting mistakes made in the financial statements of the client. In the other case, the auditor did not adequately assess the appropriateness of the client’s accounting treatments concerning available-for-sale investments and convertible notes.

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.



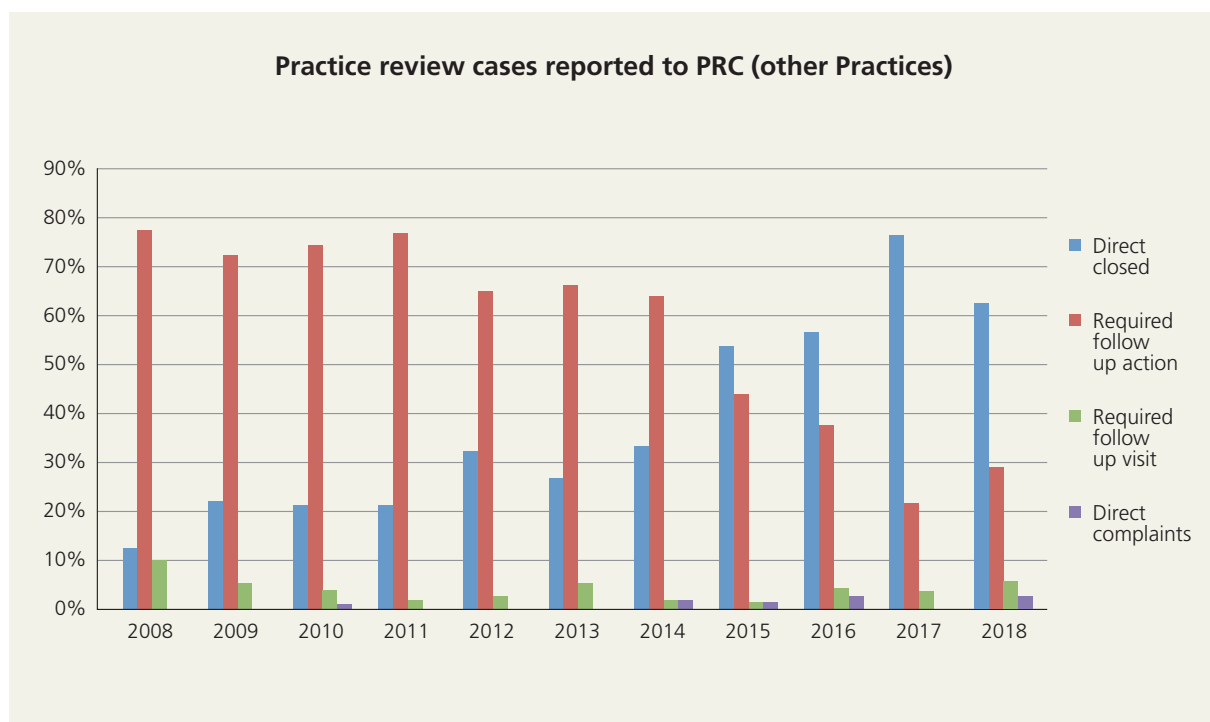
Practices without listed clients

For practices without listed clients, 61% of the reviews were directly closed in 2018, representing a decrease of 15% from 2017. The reviews that required follow up action have increased from 21% in 2017 to 29% in 2018. The changes reflect that the responses provided by some practices might not be robust enough to justify a direct close case, or reviews identified some significant deficiencies in practices' quality control system and / or audit engagements, thereby requiring some follow up actions, including monitoring work, to be undertaken.

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 2014, the PRC advised practices that it is prepared to take robust actions against a practice that failed to take proactive actions to avoid the Top 5 findings (defined on page 11) from occurring in their practice as such behaviour amounts to serious professional misconduct. In 2018, six first time reviews of other practices resulted in complaints being raised by the PRC. All of these reviews identified Top 5 findings to a significant degree. Some also found circumstances that raised issues about the professional conduct and integrity of the practices (e.g. having issued a compliance report without carrying out any work or having created additional working papers in response to practice reviews).

In addition, two 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.

Since practices are accorded the privilege of practice by virtue of being a practice unit registered with the Institute, they have to comply with professional standards regardless of whether the practices consider those standards as too demanding for their size and client portfolio.



Initiatives and measures to uphold audit quality

In recent years, we introduced a number of initiatives and measures to uphold audit quality. We also noted the efforts made by practices to prepare for practice reviews and to improve their audit work. The following reminds practices of the initiatives and measures that have been introduced since 2014 and continue to be in effect.

Letter to all practices concerning Top 5 findings

In 2014, a letter was sent to all practices setting out the PRC's decision to take stronger action against the Top 5 findings (including no or insufficient quality control policies and procedures; no or ineffective monitoring; unsatisfactory subcontracting arrangements; inappropriate audit methodology; and misuse of modified opinion). If a practice is found to have made no or little attempt to avoid those common findings, the non-compliance will be regarded as serious professional misconduct and may result in disciplinary action, even for a first time review. Since the issue of this letter, a few cases that featured Top 5 findings were referred for disciplinary actions.

E-Seminar and Audit Health Screening Checklist

In 2014, we developed an e-Seminar "Improve audit quality – Practice review and common findings" and an Audit Health Screening Checklist to help practices identify common deficiencies and take appropriate actions to address those deficiencies. Practices that are identified as having a certain extent of common deficiencies by the Audit Health Screening process are notified and their practice review will be deferred for a short period of time such that they can take appropriate remedial actions to address the deficiencies. Robust actions will be taken against them if the level of improvement is assessed to be unsatisfactory in their subsequent practice review. We now include a link in our practice review notification letters to encourage practices to enroll for the e-Seminar in advance of their practice review so that they can gain knowledge of how to better prepare for a practice review. The e-Seminar is currently available for subscription at the Institute's website and the link is set out below:

<http://mas.hkicpa.org.hk/mycpa/public/event/view/FB002A53B9EA42E7B1AFCB52D53F4C13>



Desktop reviews

In late 2014, we introduced desktop reviews for small practices without any pre-determined risk factors to better utilize our resources and to enable us to carry out more reviews each year. Desktop reviews take place at the Institute's office and entail a review of the latest monitoring report and a selected engagement of the practice.

After using desktop reviews for a few years, we believe they are effective for reviews of small practices. In 2017, we reviewed and extended the scope of desktop review to cover more practices without predetermined risk factors. We also introduced an initial self evaluation process for low risk practices with only a handful of private audit clients as part of desktop reviews since late 2017. A full scope review will however be scheduled for those practices once their number of clients has reached a certain level.

New elements in the practice review selection process

In 2016, to address concerns over the quality of audits of listed companies, we introduced additional elements to our selection process to ensure (1) practices are reviewed in the first year after they signed off audit reports on their first listed audit clients and (2) those practices that are the subjects of recent referrals to the FRC and complaints and that with significant or regular changes in the number of their listed audit clients will receive an additional interim review within their normal three-year review cycle. Through these additional visits, we will check whether practices have the required competency and resources to audit a listed client and have taken appropriate remedial actions to address deficiencies previously identified in a timely manner.

A six-year review cycle for practices without listed clients

In 2017, we introduced a plan to shorten our review cycle for practices without listed clients to 6 years. We hope to be able to achieve this target within a few years' time and to complete the reviews of practices that have not yet been reviewed under the revised practice review programme as soon as resources available permit. A cycle of 6 years is the benchmark used by many overseas regulators for similar reviews and we believe that having a fixed year review cycle would help set expectations and make practices better maintain their quality.

In addition to the above, in order to properly discharge our practice review responsibilities, we will continue to take robust actions against conduct that hinders or disturbs the practice review processes. The following are examples of robust actions taken:

- a) During practice reviews, we encountered cases where working papers and documentation were prepared or added just before the start of the practice review. It is important to note that HKSA 230 requires documentation of any changes to working papers subsequent to the completion of file assembly and reasons for making the changes. Adding working papers in reaction to practice review notification is unprofessional and unacceptable and creates serious doubts as to whether sufficient and appropriate audit evidence has been obtained before the audit report is issued. Practices should be aware that 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.

Practices are required to complete a practice review EQS every one to two years. We will check the information reported in the EQS as part of our standard procedures in a practice review. During practice reviews, we found some practices that had reported false information in the EQS intentionally in an attempt to manipulate the chance of being selected for a practice review. Such acts raise concerns about the integrity and professional conduct of the practitioners.

In our programme, the PRC has decided to take disciplinary actions against a number of practices which had added working papers in reaction to practice review notifications and / or reported false information in the EQS intentionally.

- b) Practices shall cooperate with the QAD to accommodate practice review site visit and to provide any record or other document which the reviewer reasonably believes is or may be relevant to the practice review. During practice reviews, we found a few cases where practices had not been cooperative in or had taken actions that deliberately hindered the practice review process, even after the PRC issued an instruction ordering the practices to be cooperative. Practices should be aware that such behaviour prevented the PRC from performing its statutory function and undermined the Institute's system to uphold quality and amounted to professional misconduct. So far, the PRC has decided to raise complaints against practices that were uncooperative in the practice review process.

We shall continue to enhance our review approach and introduce new initiatives and measures with an aim to promote further improvements in quality of the audit profession.

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 monitors compliance with professional standards by members engaged in the preparation or audit of listed company financial statements.

	1 year	2 years	3 years	4 years	5 years	
	Em	Em	Em	Em	Em	
	6,573	2	157	6,792	3,340	1,866
	9,768	582	701	11,051	11,615	6,292
	6,271	1,037	943	8,251	7,274	5,024
	23,522	938	557	25,017	27,091	24,638
	26,603	8,446	8,838	43,887	40,687	30,867
	1,275	542	950	2,767	2,645	2,481
	26,767	6,559	5,970	39,296	32,899	26,448
	19,542	2,055	49,287	70,884	65,286	57,535
	11,537	3,783	12,602	27,922	26,323	26,459
	3,175	4,410	6,833	14,218	13,909	13,044
	1,308	104	85	1,497	1,250	
	136,341	28,458	86,723	251,522	232,319	194,654
	64,558	2,450	2,234	69,242	52,234	48,183
	200,899	30,908	88,957	320,764	284,553	242,837
	38,706	20,481	32,979	32,166	90,606	74,027
	27,832	10,266	19,798	896	45,951	34,555
	66,538	30,747	52,777	52	136,557	108,582
customers – gross	267,437	61,655	141,734	41,512	421,110	351,419
customers – net				466	(3,684)	(4,168)
					417,226	347,251

Under this programme, the QAD carries out reviews of Hong Kong listed company financial statements to identify if there are any matters that indicate possible non-compliance with professional standards. Enquiry letters are issued to members (primarily auditors of the listed companies) for 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 unless evidence obtained is sufficient for the QAD to pursue a complaint itself.

Changes are often made to the 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 such as 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 2018 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

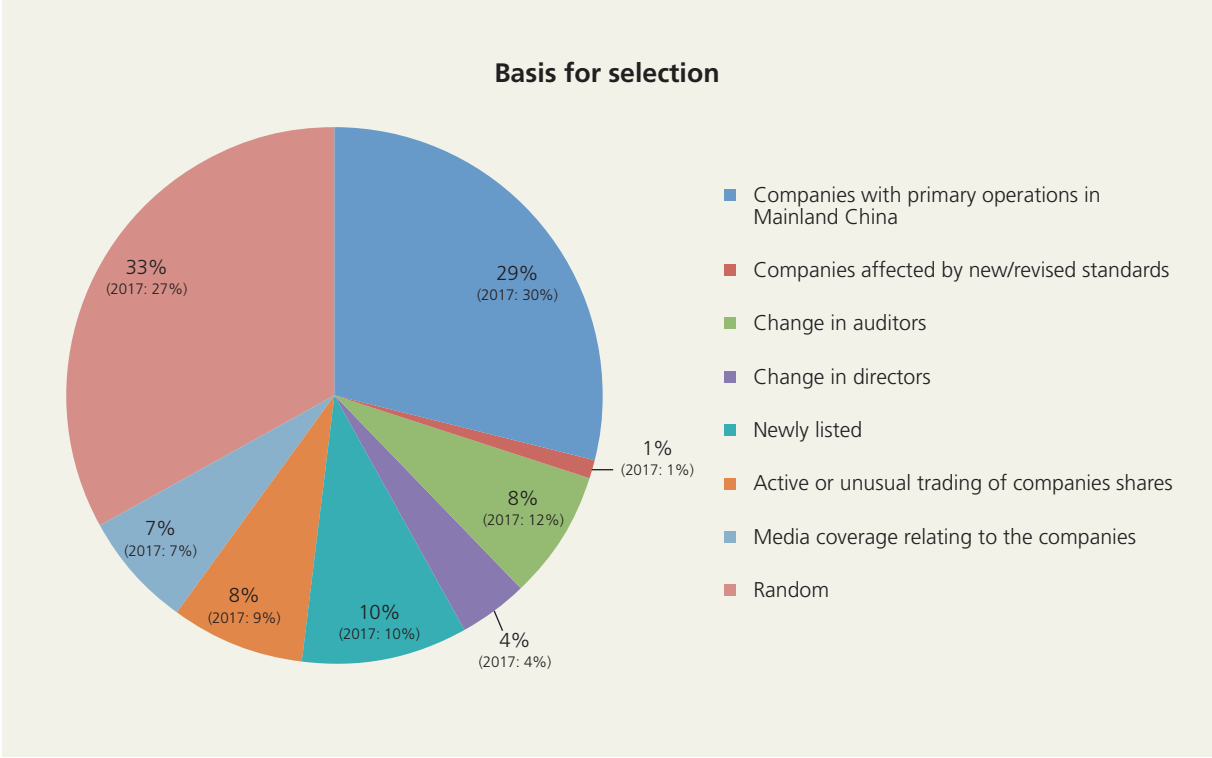
Stage 2 – QAD review

- 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

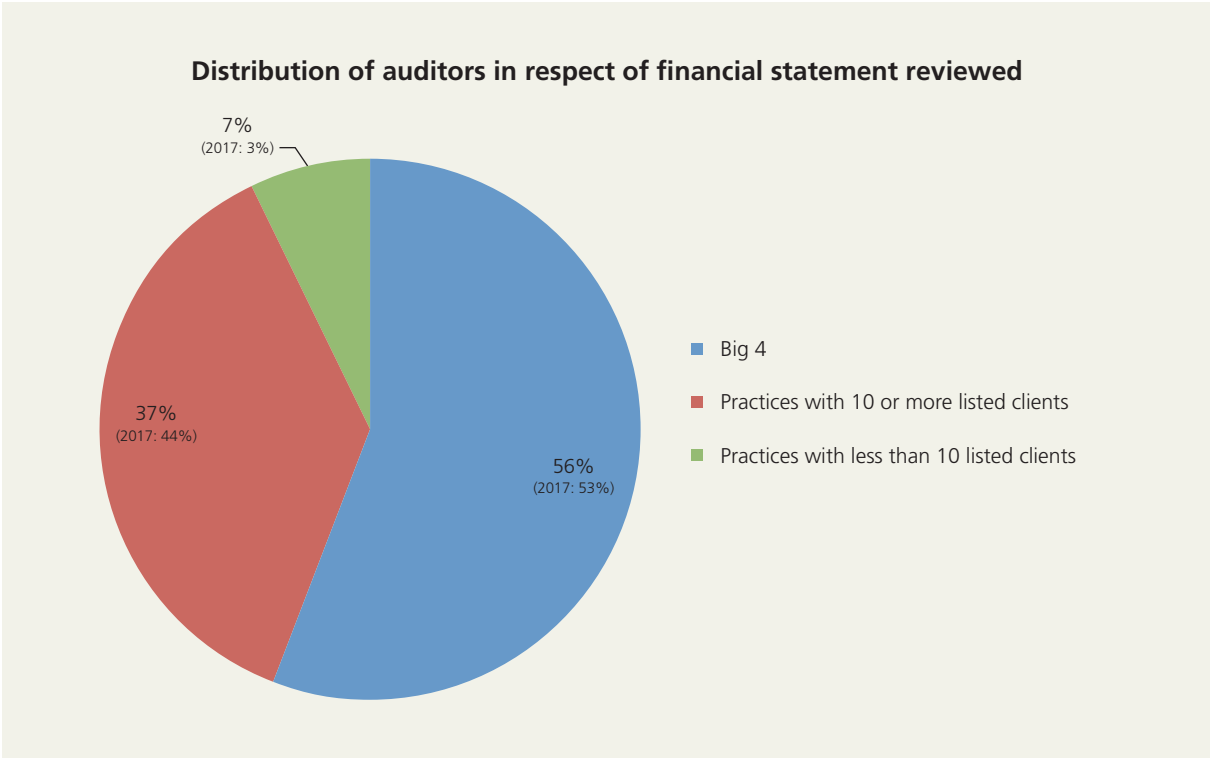
The programme uses a risk-based approach to select financial statements for review. The following chart shows the basis of selection of financial statements reviewed in 2018.



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. As there were no major changes to financial reporting standards in the past two years, only a small portion of financial statements reviewed were for “Companies affected by new/revised standards” in 2018. However, in view that two major Standards (HKFRS 9 *Financial Instruments* and HKFRS 15 *Revenue from Contracts with Customers*) were issued although not yet effective for the financial statements reviewed in 2018, an emphasis of our review for 2018 was placed on the disclosures made by the listed companies in their financial statements about how they assessed the possible impacts on initial application of these new Standards. Please see “Our findings – Professional standards monitoring programme” for more information about our commentaries on those disclosures made.

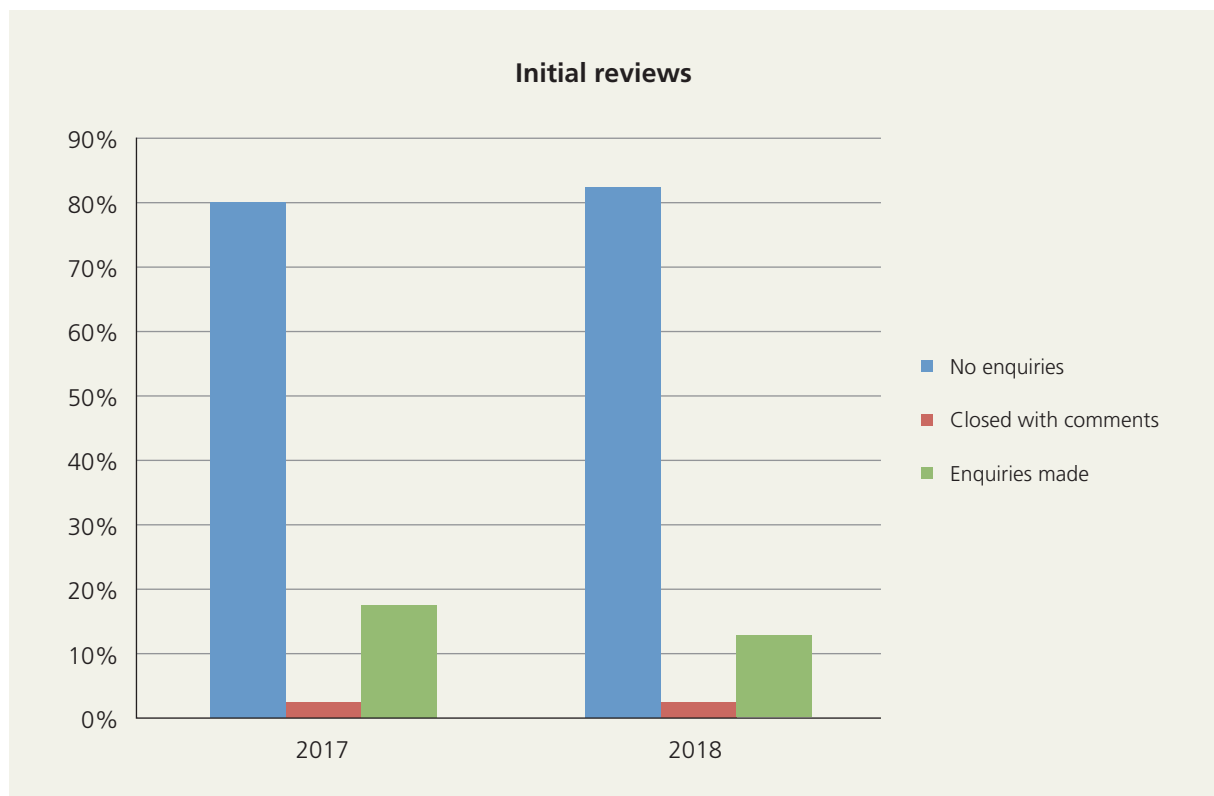
The following chart shows the distribution of auditors of the financial statements reviewed in 2018:



Our review outcomes

In 2018, the QAD achieved its review target with a total of 73 sets of financial statements reviewed. The QAD also followed up 9 cases brought forward from the previous year. During the year, the QAD issued 17 letters enquiring about matters identified from reviews or making recommendations on improvements in presentation and disclosures. The QAD handled a total of 16 responses from auditors during the year.

The chart below shows that follow up action was not needed for the majority of financial statements reviewed in 2018.



Referrals are made to the FRC for investigation when the QAD identifies potential significant non-compliance with professional standards. Since 2010, a total of 15 cases have been referred to the FRC for investigation including one in 2018.

Our findings

Practice review programme

This is the twelfth annual report on our revised practice review programme. Every year, we use the annual report to communicate common findings identified in practice reviews. To be clear, it is not that all these findings arise in all practice reviews, but rather these findings recur more frequently and therefore it is worthwhile communicating them for practices' particular attention. In 2018, we carried out 219 onsite and 90 desktop reviews, including 14 follow up visits. Most practices were cooperative and willing to make improvements to their systems, policies and processes to address deficiencies identified in their practice reviews.

The results of the 2018 practice reviews show that the majority of practices have adequate quality control policies and procedures and audit methodology to demonstrate compliance with professional standards such that we could close our reviews without the need to follow up. However, we still identified some deficiencies that have been regularly found in previous years and communicated to members and practices in publications and events. To help avoid those deficiencies, practices should build a more robust and effective quality control system and make audit quality a prime focus in carrying out audit work. We therefore hope that more efforts be made by practices to strengthen those areas.

We highlight below key areas in which common deficiencies were found and on which practices should focus to improve effectiveness of quality control and enhance audit quality. We also discuss below some deficiencies that require practices' particular attention. The areas covered in this report are as follows:

- Quality control;
- Audit process;
- Professional skepticism;
- Group audits;
- Accounting estimates; and
- Anti-money laundering monitoring.

Practice review findings may change from year to year. It is important to take note that previous annual reports might contain information that remains useful for practitioners. Practices are therefore encouraged to browse through those previous annual reports.



Quality Control

An effective system of quality control supports maintenance of quality of audit work. It is therefore important for a practice to have strong quality control not only at the engagement level but also at the firm wide level in order to drive up the effectiveness of the overall system of quality control.

Acceptance and continuance

During our reviews, we noted that, in some cases, the procedures regarding acceptance and continuance with engagements were not effectively implemented. Examples include:

- Accepting appointment as auditor before completion of the acceptance procedures (including obtaining professional clearance from the previous auditor).

Before accepting a new client, practices should perform appropriate acceptance procedures, including obtaining background information on the potential client and its officers, watching out for any information that may lead to the conclusion that the potential client lacks integrity, reviewing the previous years' auditor's reports, asking the potential client about its reasons for changing auditors, and requesting professional clearance from and enquiring with the previous auditor about disagreements, management's integrity, uncollected fees, or other issues that might have an implication for acceptance. According to the Code of Ethics ("COE"), practices should write to the previous auditor to request it to advise whether there are any issues or circumstances that might influence the potential auditor's decision to accept the appointment. As a matter of professional courtesy, the previous auditor should endeavor to provide a response to a professional enquiry. If practices do not receive a reply from the previous auditor within a reasonable time, they should endeavour to get in touch with the previous auditor by some other means. Practices should send a final letter asking for at least a negative response by a fixed date.

- Failure to assess the competence and capabilities, including time and resources, to undertake the engagement.

HKSQC1 requires a practice to consider its competence and capabilities before accepting a client relationship or an engagement. This is particularly crucial if the potential client operates in a specialized industry e.g. a licensed corporation registered with the Securities and Futures Commission ("SFC"). In some practice reviews, we found that the practitioner handled a large client portfolio in the practice under practice review and was also heavily involved in the operations of another practice being one of its engagement directors. We questioned how the practitioner was able to adequately handle such a large number of engagements and whether the resource implications had been carefully considered before accepting an appointment or reappointment. We expect to see that all key factors considered before coming to the acceptance/ continuance decision have been appropriately documented.

- Insufficient evidence to show that practices had considered the implication of their potential clients having received qualified or disclaimer reports on prior year financial statements in their assessment of client acceptance or continuance.

If a potential client received a modified report on its prior year financial statements, an understanding of the matters that gave rise to the modified report should be reached before acceptance. In particular, consideration should be given to whether those matters concern a limitation on the scope of the work of the previous auditor and how those matters would affect the audit engagement if accepted. A limitation on the scope of audit work should immediately raise concerns. Limitations can include restricted access to information, or inability to carry out some normally required audit procedures such as sending confirmation requests to customers or suppliers. In those situations, the practice should carefully assess the implications, and if they ultimately decide to accept the appointment or re-appointment, the reasons for the decision should be carefully and clearly documented. However, according to the COE, if a practice considers that the limitation imposed by a client on the scope of its work will result in issuing a disclaimer of opinion on the financial statements, the practice should normally not accept the appointment or reappointment.

Comply with ethical requirements

The COE and auditing standards stress the importance of auditor independence in an audit engagement. In a number of practice review cases, the independence issues found were due to inadequate quality control policies and procedures or insufficient knowledge of the independence requirements of the COE.

Here are some examples of issues identified during our reviews:

Provision of non-assurance services

- There was no evaluation of the significance of threats to independence arising from the provision of non-assurance services such as company secretarial services and taxation services to an audit client, and no appropriate safeguards in place to mitigate the threats.
- Accounting and book-keeping services and audit work were performed by the same staff members.
- There was a lack of evidence to show that the fees charged for non-assurance services had been communicated to the audit committees.
- A practitioner acted as company secretary or a nominee shareholder of an audit client although this is not permitted by the COE and the Companies Ordinance.



Practices are reminded to take note of the following matters when providing taxation, book-keeping and secretarial services to an audit client:

- Avoid assuming any management responsibility for an audit client such as taking on the responsibility for the preparation of financial statements.
- Limit the work to providing routine administrative services to support the company secretarial function of an audit client (such as preparing annual returns or minutes for client approval) which would not normally create a significant independence threat. However a self-review threat would arise in relation to the provision of non-assurance services, such as (1) preparing management accounts from the client-prepared trial balance or (2) preparing calculations of current and deferred tax liabilities (or assets) which have a material effect on the financial statements of an audit client. In those situations, practices should apply appropriate safeguards to address the threats created, such as using a non-audit staff member to perform the services.

As the nature and significance of threats created by a particular non-assurance service may differ, it is therefore important to carefully evaluate the threats so arising and to apply appropriate safeguards to either eliminate them or reduce them to an acceptable level. Practices should properly document their “threats and safeguards” evaluation.

Partner rotation

- Key audit partners, including engagement partners and engagement quality control (“EQC”) reviewers, were involved in the audits of the relevant listed clients beyond the seven-year allowable periods.

For Hong Kong listed clients, there is a seven-year mandatory key audit partner rotation requirement, followed by a mandatory two-year cooling off period. Practices are reminded that, for audit engagements for financial periods beginning on or after 15 December 2018, the revised long association provisions in the COE will require the cooling-off period to be extended to five years for engagement partners and three years for EQC reviewers in audits of public interest entities. These provisions will also impose a prohibition on the engagement team consulting with a former engagement partner or EQC reviewer on a technical or industry-specific issue during the cooling-off period; and new restrictions on acting as a “client relationship” partner or undertaking a role or an activity in the provision of non-assurance services to the relevant clients. Affected practices are advised to further review their resourcing needs, in particular the need for more experienced or qualified senior personnel if they have not yet done so.

Referral fee

- A practitioner paid referral fees to a non-CPA for introducing audit clients to the practice.

Section 450.13 of the COE does not allow practising members to give any commission, fee or reward to a third party in return for the introduction of a client, unless he or she is either their employee or another professional accountant. A payment of a referral fee to a non-CPA is a breach of the COE.

Confidentiality rule

- A practice shared its office with some third parties, but there were no policies and procedures in place to maintain confidentiality of audit clients' information.

In order to comply with the confidentiality rule, practices should establish procedures for access restrictions and confidential storage of audit working papers and other engagement documents.

Other quality control issues

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

- Practices did not properly supervise their subcontractor's audit work nor carry out effective reviews of the subcontracted engagements.
- EQC reviewers did not identify significant non-compliance with auditing or accounting standards in the key audit areas reviewed.
- No appropriate follow-up actions were developed nor implemented to address the deficiencies identified by the monitor.
- Some key hardcopy audit working papers were not in the assembled hardcopy audit files.

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 relevant to them.

Audit process

Audit risk assessment

Risk assessment is critical for an effective audit. If an audit team takes effective steps to adequately identify and assess risks and appropriately link the risk assessment to the procedures that they perform, the audit should stand a higher chance of uncovering material misstatements.

Related issues identified during our reviews include:

- Insufficient work to identify audit risks pertaining to specific assertions or to design specific audit procedures to respond to assessed audit risks.
- No in-depth understanding of the client's business operations (including the nature of revenue and basis of revenue recognition) and its control environment.
- No preliminary analytical reviews as part of the risk assessment procedures.

- Failure to perform adequate work to address fraud risk in revenue recognition, or having inappropriately rebutted the fraud risk presumption without sufficient grounds.
- No consideration of events or conditions that might contribute to fraud risk factors, i.e. incentives, opportunities, and rationalizations, in risk assessment.
- No selection of journal entries with fraudulent risk characteristics for journal entry testing.

HKSA 315 requires practices to undertake risk assessment procedures which include inquiries of the client management, analytical procedures, and additional procedures such as observation and inspection. Practices are required to obtain a thorough understanding of the client's business and environment in order to appropriately identify and assess risk, develop an appropriate audit strategy, and design and perform effective audit procedures. Practices should not automatically assume that because the client entity is small, there are no audit risks or that the risks of material misstatement should be the same as the previous year.

When assessing the risk of fraud, practices should consider incentives and pressures to commit a fraud, opportunities to perpetrate a fraud, and attitudes and rationalizations used to justify committing a fraud. Revenue recognition is regarded as an accounting area at risk of fraudulent financial reporting, as it is susceptible to management bias and earnings management techniques. HKSA 240 gives an example that the presumption of fraud risk in revenue recognition may be rebutted where the client undertakes a single type of simple revenue transactions (e.g. property rental). Where the revenue transactions are more complex, practices should always treat revenue recognition as a significant risk and design appropriate audit work.

Execution of key audit procedures

In our reviews, we sometimes found issues on audit execution which had an adverse effect on the level of audit comfort obtained from the audit procedures and therefore raised questions on whether sufficient audit evidence had been obtained.

Tests of controls

In respect of tests of controls, we identified the following common issues:

- Audit teams performed tests of controls some time before the relevant year-end date and only confirmed that there were no significant changes in internal controls over the remaining period through inquiry of management.
- Audit teams relied on client's internal controls even though the relevant tests of controls only covered part of the year.
- A very low sample size (e.g. one sample) was used in tests of manual controls.



Practices are reminded that a control test should cover the whole of the accounting period. When determining a sample size for a control test, practices should consider factors, including the frequency of controls (e.g. multiple times per day, daily or monthly controls), the population size and the level of evidence that is judged to be necessary. When practices perform tests of controls some time before the relevant year-end date, they should obtain corroborative evidence to confirm that controls are operating during the remaining period.

Substantive analytical procedures

In some cases, we found that the substantive analytical procedures performed did not meet the requirements of HKSA 520 and therefore would not have provided the comfort intended. Examples are as follows:

- Analytical procedures were performed by making comparison of data between current and previous year with only an explanation of the fluctuation. No independent expectation nor threshold was set to determine whether a further investigation was needed.
- No evidence of work performed to assess the reliability of the data from which the expectation of recorded amounts was developed.

When practices consider using substantive analytical procedures as a substantive audit procedure, they should ensure that (1) there are appropriate relationships between the data used and the balance tested; (2) source data is adequately tested; (3) suitable thresholds are developed; and (4) explanations for variances are obtained and corroborated with appropriate audit evidence.

Test of details - audits of revenue and expenses

Revenue and expenses are usually significant accounts, and often involve audit risks that warrant special audit consideration. We found instances where audit work on revenue and expenses was insufficient. Examples include:

Manufacturing and trading companies

- Audit teams did not review the shipping terms (e.g. "Free on Board" or "Cost, Insurance and Freight") to ensure that sales and purchases were properly recognized and that there were no goods in transit at the balance sheet date.

Retail companies

- Retail sales are often made on cash on delivery terms. A point of sales ("POS") system is commonly used by retailers to capture sales transactions and receipts of payments from customers. The total sales captured by the POS system would then be posted to the accounting system. Audit teams did not obtain an understanding of the controls over the POS system nor perform work to check the completeness of sales. In order to enable sufficient comfort be gained on the occurrence of sales, it is important to undertake work to adequately check the integrity of the sales report generated by the POS system. Audit teams should therefore identify key controls over the POS system and properly evaluate and test those controls before placing reliance on the sales report generated from the system.

- Retail sales are also very often made up of a number of small value items. Because of this, substantive work alone might not be able to obtain sufficient evidence to support the total retail sales figure. However, audit teams only relied on substantive transaction tests and did not perform additional work, such as tests of controls, to attain reasonable assurance on sales.

Construction companies

- Our reviews identified cases where contract revenue was recognized only when the construction work had been completed and/or contract costs were recognized when invoices from suppliers were received, instead of by reference to the stage of completion of the contracts. Audit teams however did not challenge their client's accounting treatment and the adequacy of financial statement disclosures.
- When the stage of completion method was applied, audit teams did not perform audit work to assess whether it was probable that the total contract cost would exceed the total contract revenue such that an expected loss on the contract would have to be recognized immediately as an expense.

Owners' corporations of buildings

- No audit work was performed to identify the nature of expenses that passed through the renovation reserve, assess whether they related to the work specified in the renovation contracts and met the special purpose of the renovation reserve approved by the management committee.
- Audit teams did not perform a budget to actual expense variance analysis and obtain an explanation from the management about significant variances, in particular unbudgeted purchases or expenditure.

School

- No work was performed to check (1) whether the client had used government subventions for designated purposes; and (2) whether the balances of individual grant accounts were, in all material respects, correct.
- No assessment was made as to whether the client's financial statements were prepared in accordance with the specific requirements of the Code of Aids, relevant letters, circulars and guidelines issued by the Education Bureau.

Securities brokers

Auditors of SFC licensed corporations ("LCs") are required to perform sufficient work to support their conclusion in the compliance report and their opinion in the auditor's report of a LC. Our reviews found cases where there was non-compliance with requirements of PN820 and HKSAE 3000. The following deficiencies were identified in our reviews of LC audits:

Compliance work

- No evidence of work done on tests of controls over (1) deposits of client money into trust bank accounts within one business day and withdrawals of client money only for prescribed purposes; (2) margin calls for shortfall of payments; (3) depositing and transferring client securities and securities collateral; and (4) reconciliation of clients' money and securities.
- No work to check that the LC had provided written confirmations of renewals of standing authorities to its customers within one week (i.e. 7 calendar days) of expiry dates.
- No review of correspondences between the SFC and the LCs.
- No reading of SFC's press releases and public register of licensed persons on the SFC website to check for any disciplinary actions or licensing conditions imposed on the LC.
- Not checking of the appropriateness of the haircut percentage applied to the value of collaterals when calculating the liquid capital reported in the financial return.
- No audit procedures performed to assess the reliability of confirmations received from customers e.g. no verification of the customers' signatures on confirmations against client agreements.
- No work performed to assess reliability of statements generated from the LC's information technology system used as evidence for audit testing.
- No arrangement for direct confirmations from the central clearing houses to confirm the stock portfolios held by the LC on behalf of customers.
- No work performed to ensure that the LC did not hold client assets where it was not authorized to hold client assets.

Audit of financial statements

- No evidence of an understanding of and, where applicable, appropriate testing of effectiveness of internal controls over information technology systems relevant for financial reporting.
- Not obtaining an understanding of the LC's anti-money laundering procedures.
- Not carrying out additional fraud risk assessment (including consideration of fraud related factors relevant to the regulated entity such as backlogs in key reconciliations and inadequate segregation of duties) as suggested by PN 820.
- The engagement letter did not set out reporting requirements under the Securities and Futures (Accounts and Audit) Rules.

The evidence that we have gained through practice reviews indicates that not all auditors of LCs are thoroughly conversant with the guidance and recommended procedures set out in PN 820. Given the public interest in regulated clients, it is important for auditors of LCs to acquire and maintain adequate technical competence before carrying out audit work on LCs. Practices are reminded to: (1) ensure appropriate supervision and review by senior staff and the engagement partner of work carried out by audit teams in compliance and financial statement audits; and (2) provide sufficient training for partners and staff who perform LC audits.

Auditor reporting

Key audit matter ("KAM")

The revised auditor reporting standards that require more informative and insightful auditor reports have been applied since their introduction in 2016. Below are issues identified in the application of those standards:

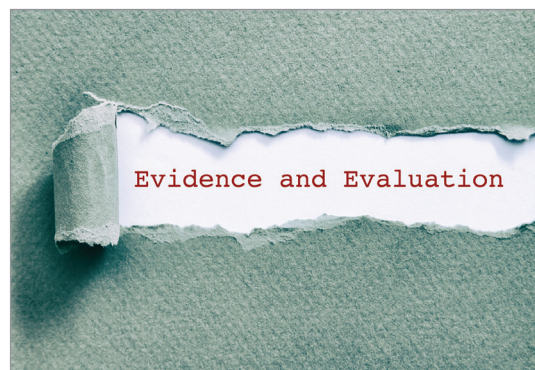
- The audit work described in the auditor report did not fairly reflect the work documented in the audit file.
- There was no evidence to show that a reported KAM was included in the communication to the audit committee. Conversely, some accounting and auditing issues were communicated with the audit committee, but there was no documentation of the rationale for not determining them as KAMs.
- No documentation was provided to support why a key accounting and auditing issue (e.g. impairment assessment of goodwill and intangible assets) was not considered as a significant risk and therefore a KAM, in particular when it involved significant management judgment, and required the involvement of both a management's expert and an auditor's expert.

Under HKSA 701, KAMs are those matters that, in the auditor's professional judgment, are of most significance to the audit of the financial statements. KAMs should be selected from matters communicated with those charged with governance and, in most of the cases, would relate to significant or complex matters disclosed in the financial statements, e.g. valuation of goodwill and other non-current assets, valuation of financial instruments, revenue recognition, assessment of impairment, taxation matters, and business combinations. Practices are required to document the rationale for their determination of which matters should constitute KAM. Practices should also ensure that the description in the auditor's report of how the KAM was addressed in the audit matches the work performed and is supported by the documentation in the working papers.

Professional skepticism

Professional skepticism is an important element required for a quality audit. Audit teams should maintain questioning minds, be alert to conditions that may indicate possible errors or fraud, and perform critical assessment of audit evidence.

Our reviews found instances that indicated that the audit teams had failed to exercise appropriate professional skepticism. These included:



- failing to challenge incorrect accounting treatments used by the clients, for example, in situations where (1) sales revenue was inappropriately accounted for on a gross, not a net, basis by a trading agent; (2) bank loans were not presented as a current liability although there was a repayable on demand clause in the bank loan agreements; (3) forward contracts were not recognized and measured at fair value; or (4) properties were not classified as property, plant and equipment under SME-FRS, despite there being a change in use as evidenced by leasing out the properties to third parties.
- accepting external confirmations (banks, debtors or creditors) where there were factors that gave rise to doubts about their reliability without performing further work to resolve the doubts (e.g. for confirmation replies provided by photocopies, confirmations not signed appropriately, or confirmations received by fax or email or through the clients).
- failing to obtain independent audit evidence when supporting documents were solely prepared and provided by the clients. For instance, audit teams solely relied on internally generated sales invoices without inspecting delivery documents to ascertain occurrence and cut-off of sales and existence of trade receivables.
- placing reliance on IT-generated reports (e.g. a debtor aging analysis for recoverability assessment of trade receivables, or sales reports for sales transaction and cut-off tests) without appropriately testing their reliability.
- failing to obtain audit evidence to corroborate the client's verbal representation (e.g. management representation that receivables were recoverable, no write-down of inventories was required, or a debtor or creditor was not a related party).
- placing undue reliance on valuation reports prepared by the client's valuers (e.g. valuations of vessels, convertible bonds, or retirement benefit liabilities) without evaluating the independence and competence of the valuers, assessing appropriateness of the valuation method and key assumptions used by the valuers, and testing against external data inputs into the valuations for reasonableness.

- relying solely on the work performed by the practices' own experts (internal or external) without obtaining a sufficient understanding of the work performed by the experts e.g. what source data was used and why the data was reasonable to use.

Exercise of professional skepticism is considered to be an important factor at all key stages of the audit process and has been identified as one of the key drivers of audit quality. Practices should take steps to foster an appropriate application of professional skepticism at the engagement level. These include key partners: (1) directing and supervising the audit engagement, especially in areas of judgment, significant risk and contentious matters; (2) having good business knowledge and experience to provide a basis for identifying unusual events or transactions; (3) being actively involved in leading and participating in audit planning, including audit risk assessment; (4) encouraging consultation with specialists; and (5) timely review of audit documentation.

Group audits

HKSA 600 stipulates the level of involvement required of a group engagement team in order to ensure that the underlying work performed by the component auditors is sufficient to support the audit opinion on the group financial statements. Specifically, the group engagement partner should be responsible for the direction, supervision and performance of the group audit engagement.



In our reviews, the following deficiencies were repeatedly found in group audits:

Planning

- No proper assessment of the significant and non-significant components.
- No or insufficient communications with the component auditors on the identification of the significant risks of material misstatements of the group financial statements, and the appropriate audit procedures to be performed.
- No assessment of the competence of component auditors and the standards that they apply.
- The component auditors did not provide a direct confirmation on their independence.
- No component materiality was determined. In some cases, group and component materiality were inappropriately determined at the same amount, although HKSA 600 requires that component materiality should be lower than the group materiality.

Execution and completion

- The group engagement teams obtained copies of working papers or reporting packages from the component auditors, but there was no evaluation of the sufficiency of the work performed by the component auditors to address significant audit risks.
- Insufficient audit evidence was obtained from the work performed by the component auditors on significant balances e.g. intangible assets, and property, plant and equipment of the components.
- The memoranda of work performed by the component auditors were too brief without details of the audit procedures performed on key audit areas.
- No consideration was given to whether an adjustment was needed where the components' financial year-ends were different from the parent's.
- The subsequent event review procedures of the components were not updated to the group audit report date.

Practices are reminded that, in a group audit engagement, the group auditor involvement in the work of component auditors is important. As a minimum, at the start of the audit, the group auditor shall discuss business activities that are significant to the group and susceptibility of the component's financial information to material misstatements with the component auditors. Later during the audit, the group auditor shall review component auditors' documentation of work to identify and address significant risks of material misstatement in the group financial statements and to determine whether further work should be required either at the group or component level. Documentation of the above may take the form of a memorandum that reflects component auditors' work and conclusions on identified significant risks. Practices are advised to refer to requirements set out in HKSA 600 (Revised) and Alert 18 "Documentation requirements for group auditors and practical implications for auditor regulation in Hong Kong" for guidance on relevant documentation required.

Accounting estimates

Accounting estimates involve judgment and consideration of uncertainties that might require some in-depth knowledge of the entity and its environment.

Based on our reviews, many deficiencies identified in auditing accounting estimates were in relation to the following areas:

Impairment assessment of cash-generating unit ("CGU")

- No audit work was performed to evaluate the reasonableness of key assumptions used to determine the value-in-use of the CGU, including the discount rate, annual growth rates of revenue and costs, adjustments to changes in working capital and terminal growth rate.

- Insufficient work was carried out to adequately challenge management assumptions, e.g the overly optimistic revenue assumptions and inclusion of cash flows that would not be generated under the current condition of the CGU without improvement or enhancement of its performance.

Business combinations

- Audit teams did not perform sufficient assessment of whether there were any unidentified intangible assets (e.g. customer lists) involved in business combinations.
- Insufficient work was conducted to properly assess the fair values of the assets acquired and liabilities assumed at the date of acquisition.

Inventories and receivables

- No audit work was performed to assess whether the inventory provision rates used were adequate and whether the inventory provision policy was properly applied.
- Audit teams did not appropriately assess whether the allowance for impairment of trade receivables was reasonable.

Investment valuation

- No assessment of the reasonableness for the significant changes in key assumptions, such as the risk free rate and share price volatility, used for determining the fair value of an investment.
- No consideration of the appropriateness of the reference prices used in the valuation of an investment in a private company.

Useful lives of intangible assets

- Audit teams did not obtain audit evidence to substantiate the adequacy of the amortisation period of intangible assets (e.g. customer relationships), which should not exceed the period of contractual rights.

Practices are reminded that HKSA 540 (revised) will be effective for financial statement audits for periods beginning on or after 15 December 2019. The revisions will require: (1) an enhanced risk assessment that requires auditors to think more deeply about the risks inherent to accounting estimates; (2) a closer link between the enhanced risk assessment and the methods, data and assumptions used in making accounting estimates; and (3) application of appropriate professional scepticism when auditing accounting estimates.

Anti-money laundering monitoring

The AMLO, effective on 1 March 2018, extended the scope of the relevant legislation to cover designated non-financial businesses and professions, including accountants. The Institute, being the regulator of the accounting profession, is responsible for carrying out work to monitor practices' level of compliance with relevant laws and regulations and launched an AML monitoring programme within its practice review programme in October 2018.

The AML Guidelines issued by the Institute provide general guidance to practices on designing and implementing policies, procedures and controls for anti-money laundering and counter financing of terrorism. The Institute also published the "Anti-money Laundering Procedures Manual for Accountants" that contains templates that might be used to aid documentation of the implementation of relevant policies and procedures.

Practices are required to have policies and procedures in place to address the AML laws and regulations. Practices are reminded to provide sufficient training and guidelines to their staff. Practices are also reminded that, even if they are not engaged in any specified transactions that would require more stringent AML policies and procedures to be applied, the legal obligation to make suspicious transaction reports still applies to them as it is not limited to any particular services but rather applies to all services provided by practices. Practices should therefore, as a minimum, carry out a name check on a client and its beneficial owners, regardless of what service is to be provided, against the sanction list posted on the Institute's website before accepting the client.

Expectation

In a world of increasing business complexity, it is a constant challenge for a practice to ensure that audit quality is adequately maintained. A high-quality audit is more likely to occur when the audit team members (1) possess appropriate values, ethics and attitudes; (2) are sufficiently knowledgeable, skilled and experienced; (3) have sufficient time allocated to perform the audit work. These elements are also relevant to the firm as a whole. The values, ethics and attitudes of individual auditors are influenced by the culture of their practices. To achieve a high-quality audit, practices need to have sound quality-control policies and procedures and rigorous audit processes to appropriately identify risk areas and to adequately respond to the risks identified. We therefore encourage practices to take proactive steps to avoid shortcomings such as reported above from occurring in their practice and to maintain knowledge about developments in professional standards to ensure that their quality control and audit systems remain adequate to meet the high expectation of the audit profession.



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, including the initial application of new and revised financial reporting standards. This report summarizes the key observations from our reviews in 2018.



Section I of this report sets out our commentaries on the initial application of new and revised financial reporting standards. As two major new Standards, HKFRS 9 *Financial Instruments* and HKFRS 15 *Revenue from Contracts with Customers* have been effective from 1 January 2018, we also highlight some points to note for members' attention. 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 new and revised financial reporting standards

For the periods of financial statements covered in our reviews in 2018, there were three amendments to financial reporting standards that came into effect in 2017. They are: *Amendments to HKAS 12 Income Taxes*, *Annual Improvements to HKFRS Standards 2014 – 2016 Cycle (Amendments to HKFRS 12 – Disclosure of Interests in Other Entities)* and *Disclosure Initiative (Amendments to HKAS 7 – Statement of Cash Flows)*. The first two clarify the existing requirements, whereas the third one introduced an additional disclosure requirement for entities to provide information in their financial statements to enable users to evaluate changes in liabilities arising from financing activities, including both changes arising from cash flows and non-cash changes (HKAS 7 paragraphs 44A to 44E). No specified format is provided in HKAS 7 but one way to fulfill the requirement as suggested by HKAS 7 is through a reconciliation of the opening and closing balances of liabilities arising from financing activities. We expect that this disclosure requirement should have an effect on all entities' financial statements so long as they have liabilities arising from financing activities. Except for one case where the listed entity appeared to have overlooked this new disclosure requirement, no significant deficiencies were identified during our reviews.

A technical article from Issue 12 of the IASB Investor Update discussing the application of *Disclosure Initiative (Amendments to IAS 7)* was published again in the Institute's A Plus (April 2017 edition). Members may refer to the link below for reference:

http://app1.hkicpa.org.hk/APLUS/2017/04/pdf/48_TechUpdate.pdf



New and revised Standards and Interpretations that are applicable to accounting periods beginning on or after 1 January 2018

There are a number of new and revised Standards issued by the Institute that are effective subsequent to December 2017 year ends. Amongst which, HKFRS 9 and HKFRS 15 are expected to have a wide-ranging impact on entities' business and financial reporting.

HKFRS 9 and HKFRS 15

HKFRS 9 is a new financial instrument standard to replace HKAS 39 *Financial Instruments: Recognition and Measurement*. It sets out the requirements for classification and measurement of financial instruments, including impairment, derecognition and general hedge accounting. HKFRS 9 does not only affect the financial reporting of financial institutions but all entities provided that they have financial instruments (varying from simple trade receivables to complex financial instruments contracts).

HKFRS 15 replaced previous revenue standards: HKAS 11 *Construction Contracts* and HKAS 18 *Revenue*, and related Interpretations including HK(IFRIC) Interpretation 13 *Customer Loyalty Programmes*, HK(IFRIC) Interpretation 15 *Agreements for the Construction of Real Estate*, HK(IFRIC) Interpretation 18 *Transfers of Assets from Customers* and HK(SIC) Interpretation 31 *Revenue – Barter Transactions Involving Advertising Services*. HKFRS 15 establishes a single comprehensive framework for determining when to recognize revenue and how much revenue to recognize through a 5-step approach, which is applicable to all contracts with customers except those scoped out under HKFRS 15 paragraph 5. The focus of the timing of revenue recognition changed from HKAS 18 - transfer of "significant risks and rewards of ownership" to HKFRS 15 - transfer of "control of a promised good or service to customer". 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. Therefore, revenue shall be recognized when (or as) the entity satisfies a performance obligation, which may be at "a point in time" or "over time" determined by the manner in which control of goods or services passes to customers.

Most of the listed companies' financial statements reviewed in 2018 have a financial year end date of 31 December or 31 March. Therefore, during the time when these listed companies prepared their annual financial statements for the year ended 31 December 2017 or 31 March 2018, the above new Standards have already been issued for some time although they were not yet effective. Accordingly, the preparers should have performed work to critically assess the potential impact of the initial application of these new Standards and be in a position to make some informative disclosures relevant to their particular circumstances under the requirements of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Although many financial statements with a 31 December 2017 or 31 March 2018 year end reviewed by us disclosed that management did not consider that the initial application of HKFRS 9 and HKFRS 15 in the next financial year would have a material impact on the financial position and performance of the entities, the disclosures were rather boilerplate without information that clearly reflected the facts and circumstances particular to the operations of the entities.

In a case reviewed, the listed entity engaging in sales and installation of products generally disclosed that management had performed an assessment of the impact of IFRS 15 and concluded that the transitional adjustment to be made upon initial adoption of IFRS 15 would not be material and the expected changes in accounting policies also would not have a material impact on the listed entity's financial statements. We consider that more detailed disclosures with due regard to the specific circumstances and operations of the listed entity would help users of the financial statements to understand further how the management had come to the assessment conclusions. For example, disclosing the transition option chosen by the listed entity might help to explain why the transitional adjustment to be made would not be material.

Our plan for 2019 and expectation

In our 2019 reviews, we will put more focus on reviewing the initial application of HKFRS 9 and HKFRS 15, in particular in the financial statements of the listed entities engaging in the industries which we anticipate might be more impacted by these two Standards. For example, telecommunications, construction and engineering, mining and metals, oil and gas, retailing and consumer and insurance and banking entities will be within our targeted review population for assessing compliance.



In assessing the implications of the new Standards for their businesses and financial reporting, entities should first obtain a full understanding of the relevant transition requirements contained in the new Standards such that they can evaluate the effects of the transition options and the optional practical expedients and then make an informed choice. This is important as the choice of a transition option might not only affect the costs of implementation, but also have an impact on the financial performance data presented in the financial statements (e.g. the revenue trends).

Transition requirements

As a reminder to members, we provide below an overview of the transition requirements of HKFRS 9 and HKFRS 15:

HKFRS 9 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. If the comparatives are not restated, entities should adjust the opening balance of retained earnings in the year of initial application for the cumulative effect of applying HKFRS 9. HKFRS 9 shall not be applied to items that have already been derecognized at the date of initial application.

There are also transition options available in HKFRS 15. HKFRS 15 states that entities can either use the “Retrospective method” or the “Cumulative effect method” to deal with the transition arrangements. Under the “Retrospective method”, entities are required to restate the comparatives and the opening balances of the earliest period presented. However, entities may elect to use one or more of the optional practical expedients to simplify the restatement process. For example, for complete contracts that have variable consideration, an entity may use the transaction price at the date on which the contract was completed, rather than estimating variable consideration amounts in the comparative reporting periods. On the other hand, if entities choose to use the “Cumulative effect method”, they would record the cumulative effect of initially applying HKFRS 15 as an adjustment to the opening balance of equity (generally retained earnings) at the date of initial application. Entities can also choose to apply the new requirements of HKFRS 15 to all contracts or only open (i.e. not complete) contracts at the date of initial application and may also elect to use the contract modification practical expedient.

Entities should provide sufficient transition disclosures in the financial statements to comply with the relevant disclosure requirements set out in HKFRS 7 *Financial Instruments: Disclosures* (for the initial application of HKFRS 9) and HKFRS 15, as well as HKAS 8.

The Institute has developed a webpage “New and Major Standards Resource Centre” aiming at providing members with quick access to relevant useful resources for understanding new and major Standards. The webpage is available at:

[https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/
New-and-major-standards/New-and-Major-Standards](https://www.hkicpa.org.hk/en/Standards-and-regulation/Standards/New-and-major-standards/New-and-Major-Standards)



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

In this section, we first share with you an interesting example where there was complexity involved in the initial accounting for an acquisition of an associate. We hope that this case could give members some insights on the considerations that should be given to identify the appropriate accounting treatment for a transaction that included components governed by different Standards.

We then highlight some common issues on the application of HKFRS 3 (Revised) *Business Combinations* and HKAS 36 *Impairment of Assets*, which were found in the 2018 reviews. These issues were issues that have been discussed in previous QAD reports and forums but still keep recurring. We finish by covering some common application issues on HKAS 21 *The Effects of Changes in Foreign Exchange Rates*. As it has been around 10 years since we last discussed this topic in QAD annual reports, it is a suitable time to remind members of some of the key requirements of HKAS 21 through sharing of the application issues identified in recent years.

1. Acquisition of an associate

The requirements for the accounting for investments in associates are addressed in HKAS 28 (2011) *Investments in Associates and Joint Ventures*. Such an investment is initially accounted for at cost and subsequently adjusted for the investor's share of the net assets of the associate by using the equity method.

A set of annual financial statements reviewed showed that the listed entity recognized a substantial loss arising from an acquisition of a 25% interest in an entity at a purchase consideration satisfied by issuance of convertible bonds by the listed entity on the completion date of the acquisition. The acquiree was subsequently accounted for as an associate upon completion of the acquisition.

In view of the significance and unusualness of the substantial loss recognized at the time of the acquisition, enquiries were raised with the auditor to ask them to explain the reason(s) for such loss and the basis for determining the amount of loss recognized. From the exchange of correspondence with the auditor, we were given to understand that the listed entity had applied HKAS 39 to account for the acquisition contract, which was assessed as a forward contract, from the date of entering into the contract to the date of completion of the contract on the grounds that the transaction was not scoped out from HKAS 39. The fair value change of the derivative forward contract from the contract date to the completion date was recognized as a loss in the consolidated income statement, giving rise to the substantial reduction in the amount recognized as the acquisition cost of the associate.

There are some key points in the above example that we consider worth highlighting for members' attention and consideration:

- As shown in this example, a contract entered into by an entity to buy or sell an investment in an associate or joint venture could, in principle, be a derivative forward contract within the scope of HKAS 39 or HKFRS 9. This is the case regardless of whether the consideration for the associate will be in the form of cash or another financial asset. Unlike contracts to acquire a business (HKAS 39 paragraph 2(g) or HKFRS 9 paragraph 2.1(f)), such contract is not specifically scoped out from the measurement requirements of HKAS 39 or HKFRS 9 and therefore needs to be recognized and measured at fair value through profit or loss.
- As defined in HKAS 32 *Financial Instruments: Presentation* paragraph 11, a financial liability is any liability that is a contractual obligation: (i) to deliver cash or another financial asset to another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity. HKAS 32 paragraph 13 states that "contract" refers to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.

In the above example, the initial measurement date of the derivative contract should be the date on which the contractual obligation was established – i.e. the point at which the listed entity no longer had an unconditional right to avoid delivering cash or another financial asset to acquire the associate.

Accordingly, we expected that a careful review of the contract terms should be carried out to assess when the contractual obligation arising from the derivative forward contract was established.

The contract date and the completion date of the above acquisition both fell in the same accounting period and therefore there should not have been any further financial impact in next year's financial statements after the completion of the acquisition. However, if the completion date of the acquisition took place in a subsequent financial year, a derivative financial asset or liability would still have remained on the consolidated statement of financial position at the end of the reporting period.

- In a contract to acquire an associate that will be settled entirely in cash, the underlying instrument in the derivative valuation will be the shares of the associate. However, in the case in question, the consideration for the interest in the associate was in the form of a bond convertible into the acquirer's own shares. In this case, the change in the fair value of the derivative will have been impacted by both changes in the fair value of the associate's shares and changes in the fair value of the acquirer's own shares. Specifically, since there was an increase in the acquirer's share price from the date on which the contractual obligation (initial measurement date of the derivative contract) was established to the completion date, this feature of the contract would have given rise to an increase in the fair value of the derivative liability. It was therefore correct that the change in the fair value of the derivative attributable to this change in the share price of the acquirer was recognized as a loss in the consolidated statement of profit or loss.
- The resulting derivative asset or liability then needs to be taken into account in arriving at the cost of the interest in the associate on the initial recognition of the associate. For example, in the case in question, if the increase in the fair value of the derivative liability had been 10 (resulting in a loss of 10 being recognized in profit or loss), and the fair value of the convertible bonds on the date of initial recognition of the interest in the associate had been 90, then the initial cost of the investment in the associate would be recorded at 80. In this simplified example, the consolidated statement of financial position would show the following amounts:

	Immediately before initial recognition of the interest in the associate	On initial recognition of the interest in the associate
Investment in associate (at cost)	-	80
Derivative liability	(10)	-
Convertible bonds (initially recognized at FV)	—	(90)
Net assets	<u>(10)</u>	<u>(10)</u>
Loss recognized in profit or loss	<u>(10)</u>	<u>(10)</u>

Another observation in the above case is that the listed entity had described the loss recognized in the interim financial statements as an impairment loss on the interest in the associate. A distinction of this treatment as compared to that used in the annual financial statements is that the impairment loss recognized under HKAS 36 on the carrying amount of the investment would be reversible in future periods whereas the derivative loss under HKAS 39 recognized prior to the acquisition would not be. Care should have been taken to properly explain the nature of the loss to help readers understand how the accounting policies had been applied in this transaction, as the loss on the derivative in this case was material.

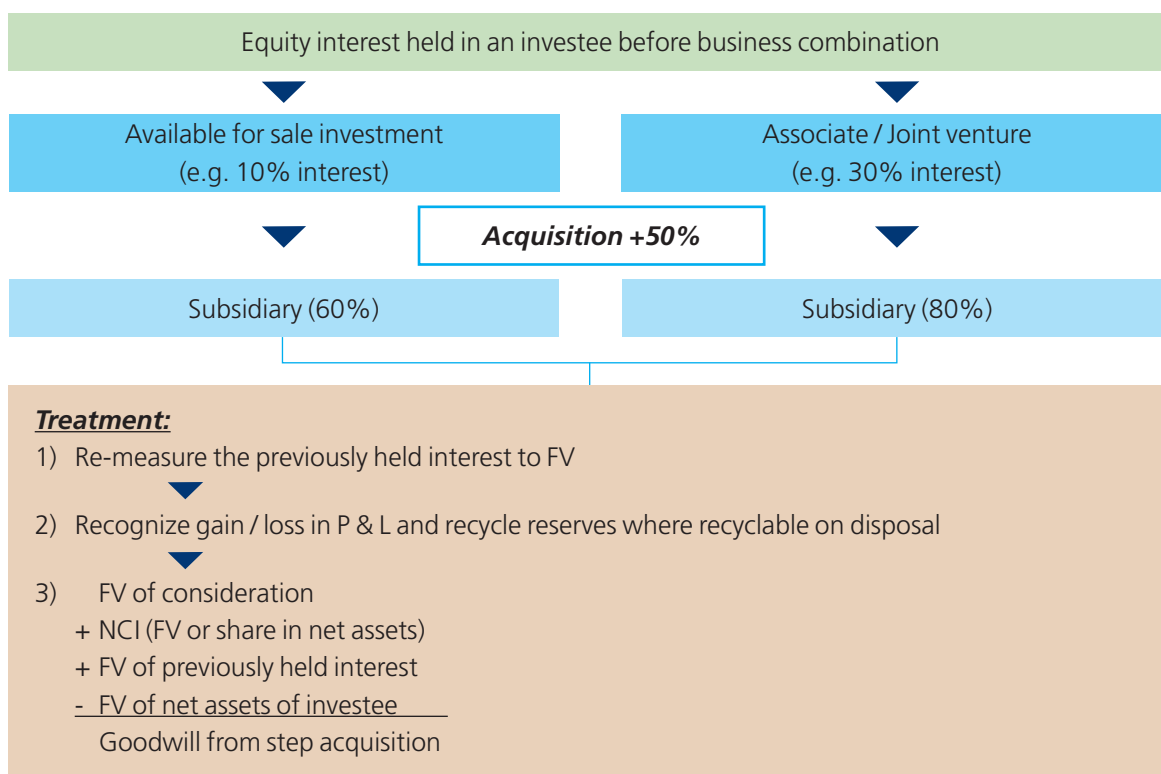
2. HKFRS 3 (Revised) *Business Combinations*

HKFRS 3 (Revised) paragraph 42 requires that an acquirer shall remeasure its previously held equity interest in the acquiree at fair value as of the acquisition date. Any gain or loss arising from the remeasurement of the previously held equity investment shall be recognized in profit or loss. In prior reporting periods, the acquirer may have recognized changes in the value of its equity interest in the acquiree in other comprehensive income. HKFRS 3 (Revised) paragraph 42 clarifies that the amount that was previously recognized in other comprehensive income shall be recognized on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.

The accounting treatment of a step acquisition (from an available-for-sale equity investment¹, an associate or a joint venture to a subsidiary) is summarized in the following flow chart:

¹ The AFS category of investment is no longer acceptable under HKFRS 9, effective for annual periods beginning on or after 1 January 2018. If the investment is classified as "fair value through other comprehensive income" under HKFRS 9, then the amount recognized in other comprehensive income and accumulated in reserves cannot be recycled through profit or loss on disposal. If the investment is classified as "fair value through profit or loss", then by definition there are no amounts to be recycled on disposal. Therefore, under HKFRS 9 there are no amounts to be recycled in a step-up from an investee (which is not an associate or a joint venture) to subsidiary, regardless of how the investee was classified prior to the step-up.

Step acquisition



A point to note is that, once an acquirer has obtained control of an acquiree, subsequent changes (either acquisitions or dispositions) of any non-controlling interests in the acquiree shall be accounted for as equity transactions in accordance with HKFRS 10 *Consolidated Financial Statements*.

In a set of financial statements reviewed, the listed entity acquired an additional interest in an associate at a purchase consideration satisfied by cash ("step acquisition"). After completion of the step acquisition, the acquiree became a wholly owned subsidiary of the listed entity.

To account for the step acquisition, by applying the formula shown in the above flow chart, the listed entity measured both the fair value of the identifiable assets and liabilities of the acquiree as well as that of the 40% previously held interest of the acquiree at the acquisition date. A gain on the remeasurement of the fair value of the 40% previously held interest was recognized in the consolidated income statement. However, we observed that the amount of fair value of the 40% previously held interest of the acquiree was not proportionate (i.e. 40%) to but instead represented 66% of the fair value of the acquiree's identifiable net assets at the acquisition date. Apart from some limited disclosures of the fair value measurement of a major asset acquired (i.e. an intangible asset) in the acquisition, no other information was provided in the financial statements to explain how the fair value measurements of the other significant identifiable assets and liabilities of the acquiree and the 40% previously held interest in the acquiree were carried out by the listed entity.

In response to our enquiry, the auditor explained that the fair value measurements of the identifiable assets and liabilities of the acquiree and the 40% previously held interests were performed on different bases and its internal valuation specialists were also involved in the evaluation of the professional valuations performed by an external valuer that was engaged by the listed entity. We have the following observations and recommendations for this case:

- (1) Information on the key assumptions and valuation inputs used in the fair value measurements should be disclosed. In addition, it is also advisable to disclose the management's critical judgment applied in determining the different bases to measure the fair value of the identifiable assets and liabilities of the acquiree and the 40% previously held interest in the acquiree at the acquisition date as required by HKAS 1 (Revised) *Presentation of Financial Statements* to enable users of the financial statements to better understand the fair value measurements applied in accounting for the step acquisition.
- (2) As required by HKSA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, an auditor shall describe in its auditor's report KAM and the audit procedures performed to deal with the KAM. While HKSA 701 recognizes that determination of KAM is a matter of professional judgment, an auditor should identify from those matters that required significant auditor attention and having been communicated with those charged with governance as KAM for reporting.

In the above example, the auditor's response explained details of the extensive audit work done, including the involvement of internal valuation specialists, to critically challenge the appropriateness of the key assumptions and the valuation bases used in the valuations. If the above matter was considered warranting significant auditor attention and had been communicated with those charged with governance, the auditor should have considered whether or not to include it as a KAM and describe how such KAM was resolved in the auditor's report.

3. HKAS 36 *Impairment of Assets*

In the 2018 reviews, we raised a number of enquiries about matters concerning the application of HKAS 36. We have discussed issues relating to impairment of assets in many previous QAD annual reports. This year's report will focus more on discussions of impairment assessment of goodwill.

Goodwill is recognized by an acquirer from a business combination. It does not generate cash flows independently of other assets and often contributes to the cash flows of multiple cash-generating units (HKAS 36 paragraph 81). For the purpose of impairment testing, an entity (acquirer) should first identify each of its cash-generating units or groups of cash-generating units throughout the group that are expected to benefit from the synergies of the combination. It is worth noting that the allocation of purchased goodwill is made independently of the allocation of the acquiree's other assets and liabilities. Accordingly, such allocation is carried out



irrespective of whether other assets and liabilities of the acquiree are assigned to those units or group of units (HKAS 36 paragraph 80). That means the newly acquired goodwill need not be allocated to the newly acquired cash-generating unit unless the entity (acquirer) concludes that the newly acquired cash-generating unit will benefit from the synergies of the combination.

When deciding the unit(s) to which goodwill should be allocated for impairment assessment, consideration should also be given to how internal management monitors the goodwill. The principal requirement is set out in HKAS 36 paragraph 80, which states that:

“Each unit or group of units to which the goodwill is so allocated shall:

- (a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and*
- (b) not be larger than an operating segment as defined by paragraph 5 of HKFRS 8 Operating Segments before aggregation.”*

HKAS 36 paragraph 82 explains that applying the requirements in paragraph 80 results in goodwill being tested for impairment at a level that reflects the way an entity manages its operations and with which the goodwill would naturally be associated. Therefore, the development of additional reporting systems is typically not necessary.

An entity is required to test goodwill acquired in a business combination for impairment in accordance with HKAS 36 (1) annually and (2) when there is any indication of impairment. The annual impairment test may be performed at any time during the financial year, provided it is performed at the same time every year. However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period (HKAS 36 paragraph 96). An impairment loss on goodwill is never reversed.

In a case reviewed, the note to the financial statements of the relevant listed entity showed some impairment indicators on the property, plant and equipment (“PPE”) and land used in product production and an impairment loss on goodwill was recognized during the year. In response to our enquiry about how the PPE and land were assessed for impairment, the auditor replied that those assets were held by a subsidiary in Mainland China (“Subsidiary X”) for production of products of three different operating segments and could not be separated on a reliable basis for impairment assessment at the segment level. Therefore the impairment assessment of the PPE and land was carried out at the level of Subsidiary X. The analysis provided in the response however further showed that the abovementioned goodwill was allocated to Subsidiary X in performing the impairment assessment. It therefore suggested that the cash-generating unit (i.e. Subsidiary X) to which goodwill was allocated for impairment assessment purposes was larger than an operating segment. This raised concerns whether this treatment met the requirements under HKAS 36. The responses did not provide details as to how the goodwill impairment assessment was actually carried out by the management.

In response to our follow up enquiries, the auditor clarified that (i) the goodwill allocated to Subsidiary X holding the PPE and land for impairment assessment arose not from Subsidiary X but from a subsidiary wholly owned by Subsidiary X (“Subsidiary Y”); and (ii) the impairment assessment of goodwill was performed at two levels, firstly at the direct subsidiary level (i.e. Subsidiary Y) and another at its immediate holding company (i.e. Subsidiary X which held the PPE and the land) level. Given that the direct subsidiary (Subsidiary Y) was engaged in production of products of one operating segment only, the goodwill impairment assessment carried out firstly at that level was considered not to have violated HKAS 36 paragraph 80.

The impairment assessment test at the immediate holding company level (Subsidiary X) was also considered to be analogous to the methodology applied to impairment assessment of unallocated corporate assets under HKAS 36 paragraph 102.

The above case is an example to show why it is important to provide clear and sufficient disclosures in the financial statements. Without the auditor’s clarifications and explanations, it would have been difficult to find out how the goodwill impairment assessment had actually been carried out by the management through reading the financial statements. We therefore consider that it would have been helpful to the users of the financial statements if the listed entity could enhance the transparency of the financial statements by providing some key information as explained in the auditor’s response, in particular the circumstances that gave rise to the goodwill and how the impairment assessment of such goodwill was carried out (i.e. firstly at the direct subsidiary level and then this subsidiary’s immediate holding company level) and the management’s judgment applied in the impairment assessment process.

Other issues that we have encountered during the 2018 reviews mainly related to the following areas:

- the appropriateness of the key assumptions used in the value in use calculation of the cash-generating unit, in particular, whether they are reasonable and supportable and represent management’s best estimate of the economic conditions that would exist over the remaining useful life of the cash-generating unit (HKAS 36 paragraph 38). Circumstances that had led to questions being raised by us include:
 - use of an increasing growth rate on sales volume although the revenue from the cash-generating unit was declining;
 - use of a gross profit margin in the projected future cash flows but such margin was higher than the actual gross profit margin attained by the listed entity in the past few years.
 - substantial future cash flows being forecast by management even though only minimal revenue had been generated in the past few years.

- Insufficient information provided in the financial statements about the cash-generating unit to which goodwill was allocated for impairment assessment.
- Insufficient information provided in the financial statements to support the conclusion that an impairment loss was required to be recognized only for the goodwill allocated to the cash-generating unit and not to the other assets within the same unit at the year end.

In the above examples, enquiries were raised with the auditors concerned to obtain more information on the impairment assessment performed by management and the audit evidence obtained to support the audit conclusion.

Similar issues have been discussed in details in previous QAD annual reports. The reports are accessible at:

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



4. HKAS 21 *The Effects of Changes in Foreign Exchange Rates*

An entity may have foreign operations or may undertake transactions denominated in foreign currencies. In addition, an entity may present its financial statements in a foreign currency. The objective of HKAS 21 is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency (HKAS 21 paragraph 1).



Two notions are used in HKAS 21 (HKAS 21 IN6):

- Functional currency – the currency of the primary economic environment in which the entity operates;
- Presentation currency – the currency in which financial statements are presented.

Here below we categorize application issues of HKAS 21 identified from our reviews in 2018 and previous years into two areas: (i) determination and disclosures of functional currency; and (ii) accounting for and presentation of foreign currency transactions and disposal of foreign operations. The key requirements are briefly recapped in the respective section.

(i) *Determination and disclosures of functional currency*

An entity should measure its assets, liabilities, income and expenses in its financial statements in its functional currency. It is an entity-specific concept and therefore the individual entities within a group (e.g. multi-national group) should determine their own functional currency. A foreign currency is a currency other than the functional currency of the entity. It is crucial to first properly identify the functional currency as it would have a direct consequential impact on the identification of and the accounting for foreign currency transactions. Judgment may be required in some cases (e.g. entities which have diversified operations and satisfied a number of the functional currency indicators under HKAS 21 on the basis of different currencies used). It is important to note that, as the determination of functional currency is a matter of fact (not a choice), an entity's functional currency would change only if there is a change in the primary economic environment in which the entity operates (HKAS 21 paragraphs 13 and 36).

Foreign currency transactions are translated at the spot exchange rate at the date of transaction. The date of transaction is the date on which the transaction first qualifies for recognition in accordance with HKFRSs (HKAS 21 paragraphs 21 and 22).

If items that arose as a result of a transaction denominated in a foreign currency are still recognized at the end of a reporting period, the approach to the translation of the items would depend on whether the items are monetary or non-monetary items, and, in the case of non-monetary items, whether the items are carried at historical cost or fair value measured in a foreign currency. Foreign currency monetary assets and liabilities are retranslated at the closing rate of the year end. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined. Other non-monetary items are not re-translated, i.e. they are stated using the historical rate (i.e. the applicable rate at the date when the original cost was measured).

Generally exchange differences arising on the retranslation of monetary items are recognized as income or expense in the period in which they arise, unless hedge accounting applies or the item forms part of the net investment in a foreign operation (HKAS 21 paragraphs 23, 27, 28 and 32). Exchange differences arising on non-monetary items carried at fair value are recognized together with the other fair value changes on that item (HKAS 21 paragraph 30).

Examples of issues that we identified from our reviews:

- *Inappropriate determination of functional currency*

The disclosures in a set of financial statements reviewed showed that the listed entity had significant foreign exchange exposure to US Dollars as many of its assets (trade receivables, cash and bank balances) and liabilities (trade payables and bank borrowings) were denominated in US Dollars. US dollars were regarded as a foreign currency (i.e. not the functional currency) of the relevant entities within the group that recorded such assets and liabilities. HKAS 21 paragraph 9 requires functional

currency of an entity to be determined with regard to its primary economic environment in which it generates income (e.g. through sales transactions) and expends cash (e.g. through purchase transactions). HKAS 21 paragraph 10(a) also states that the currency in which funds from financing activities (e.g. through bank borrowings) are generated may provide evidence of an entity's functional currency. Based on the above requirements and given that significant sales, purchases and bank borrowing transactions undertaken were denominated in US Dollars, we questioned whether US Dollars should instead be the functional currency, rather than a foreign currency of the relevant individual entities within the group that recorded such transactions.

HKAS 21 paragraph 12 states that, when the indicators under HKAS 21 paragraph 9 to 11 are mixed and the functional currency is not obvious, management should use its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. Such judgments should be disclosed in the financial statements².

- *Inappropriate concept of functional currency:*

Another listed company's financial statements disclosed that RMB was the "group functional currency". This disclosure was not appropriate as the functional currency is an entity-specific concept rather than a group concept. As this disclosure suggested that the listed entity had applied a "group concept", we had concerns whether each entity in the group had properly determined its own functional currency and items included in the financial statements of each entity were originally recorded using that entity's specific functional currency.

- *Confusing, inaccurate or missing disclosures*

- In a set of financial statements reviewed, a disclosure stated that the functional currency of the holding company was RMB but another disclosure stated that it was Hong Kong Dollars. At least one of these statements must have been inaccurate and therefore misleading.
- In another listed entity's separate financial statements, a significant exchange translation reserve was recorded. Given the exchange translation reserve is commonly used to capture the exchange differences arising from translation of the functional currency into a presentation currency (see (ii) below for more discussions), the above observation revealed that the functional currency of the holding company was different from its presentation currency. However, this fact, together with the reason for using a different presentation currency, were not disclosed as required by HKAS 21 paragraph 53.

² In its meeting in January 2010, the IFRIC considered that, how an entity applies IAS 21 for the purpose of determining its functional currency – whether it is an investment holding or any other type of entity – requires the exercise of judgment. IAS 1 Presentation of Financial Statements requires disclosure of significant accounting policies and judgments that are relevant to an understanding of the financial statements.

(ii) Accounting for and presentation of foreign currency transactions and disposal of foreign operations

HKAS 21 permits an entity to present its financial statements in any currency. If an entity decides to use a presentation currency different from its functional currency, the entity translates its results and financial position into the presentation currency.

In the above regard, assets and liabilities are translated at the closing rate (i.e. the spot rate at the reporting date) and income and expenses are translated at the transaction rates (the spot rate applicable at the date of the individual transactions). The average rate for a period can be used if it is a reasonable approximation of the transaction rates. All resulting exchange differences are recognized in other comprehensive income accumulated in a separate component of equity (often called the exchange translation reserve) (HKAS 21 paragraphs 39 and 40).

Translation and disposal of a foreign operation

Entities shall apply the requirements set out in HKAS 21 paragraphs 38 to 47 when they translate the results and financial position of its foreign operations into a presentation currency so that the foreign operations can be included in the financial statements of the reporting entity by consolidation.

In regards to a disposal of a foreign operation, HKAS 21 paragraph 48 requires that the cumulative amount of the exchange differences relating to that foreign operation, recognized in other comprehensive income and accumulated in the separate component of equity, shall be reclassified from equity to profit or loss as a reclassification adjustment when the gain or loss on disposal is recognized.

Examples of issues that we identified from our reviews:

- *Recognition of exchange reserve*
 - It is common for a Hong Kong listed company to present its financial statements in Hong Kong Dollars although its functional currency varies depending on its primary economic environment and the underlying transactions and conditions.

In a few cases reviewed, the functional currency of the holding company disclosed was RMB whereas the presentation currency of the consolidated financial statements was Hong Kong Dollars. Therefore, the translation of the holding company's financial position and results should result in some exchange differences being recognized in other comprehensive income. However, it was unclear why, in the holding company's separate financial statements, the holding company's reserves did not show any exchange movements, raising questions whether the exchange differences arising from translation to presentation currency were properly accounted for in accordance with HKAS 21.

- In another case, the presentation currency of the consolidated financial statements was RMB. A significant exchange loss on translation of the results and financial position of the operations outside Mainland China was recognized in other comprehensive income during the year. Meanwhile an exchange gain was recognized in the holding company's reserve according to a note disclosure on the holding company's statement of financial position. It was unclear why there could be a significant exchange loss arising from translation of the financial information of the operations outside Mainland China (which represented only the Hong Kong holding company and two BVI investment holding subsidiaries).
- *Release of exchange reserve as a result of disposal of a foreign operation*
 - In a case reviewed, the amount of exchange reserve that was released to profit or loss upon disposal of a foreign operation was unreasonably large as it was greater than the total exchange difference accumulated in the prior year exchange reserve recorded in the consolidated statement of changes in equity. This caused concerns whether the gain on disposal of the foreign operation had been appropriately calculated.
 - A few listed entities categorized the movements in their exchange reserves as an item that "will not be reclassified subsequently to profit or loss" in the other comprehensive income section of their consolidated statement of profit or loss and other comprehensive income. However, there was no explanation in the financial statements as to how this treatment was consistent with the requirements of HKAS 21 paragraph 48 which requires that the cumulative exchange differences accumulated in other comprehensive income shall be reclassified to profit or loss on the date of disposal of the foreign operation. Therefore it was not clear whether this assertion was as a result of a choice of presentation currency for the parent company or was a result of non-compliance with HKAS 21 paragraph 48.

Auditors should critically assess the appropriateness of the functional currency determined by client management for each major entity within the client group as it would have a consequential impact on the consolidated financial statements. Appropriate consideration should be given to whether the judgment applied by management is reasonable and supportable based on relevant facts and circumstances.

As a reminder, the Institute issued HK(IFRIC) Interpretation 22 *Foreign Currency Transactions and Advance Consideration* in June 2017 with a further revision made in September 2018. The Interpretation provides guidance on how to determine "the date of transaction" for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income (or part of it) on the derecognition of a non-monetary asset or liability arising from the payment or receipt of advance consideration in a foreign currency (HK(IFRIC) Interpretation 22 paragraph 7). The Interpretation was effective for annual reporting periods beginning on or after 1 January 2018.

Section III – Common disclosure deficiencies

Save for the disclosure deficiencies discussed in Section I and Section II of this report, the following is an overview of the other common disclosure deficiencies identified in our 2018 reviews:



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

The following disclosures were often missing or incomplete:

- 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 the amounts expected to be recovered or settled within 12 months with those expected to be recovered or settled after 12 months (HKAS 1 (Revised) paragraph 61); and
- the nature of the major components of significant balances such as other receivables, deposits and other payables (HKAS 1 (Revised) paragraphs 15, 17(c) and 112(c)).

2. HKAS 12 *Income Taxes*

The following disclosures were often missing or incomplete:

- The expiry date of the unused tax losses for which no deferred tax asset is recognized in the statement of financial position (HKAS 12 paragraph 81(e)); and
- The aggregate amount of temporary differences associated with investments in subsidiaries (e.g. undistributed profits) for which deferred tax liabilities have not been recognized (HKAS 12 paragraph 81(f)).

In a case reviewed, the disclosure of the reconciliation of the group's tax expense and profit before tax included a significant item "Others". As the item was significant, we considered that the entity should have provided some descriptions and explanations about the item (e.g. the nature and how it arose) in the financial statements in order to help users better understand the relationship between the group's tax expenses and accounting profit (HKAS 12 paragraphs 81(c) and 84).

3. HKAS 24 *Related Party Disclosures*

We found some disclosures of related party transactions were insufficient to enable users of financial statements to understand the nature and extent of related party transactions and balances and raised questions about the completeness of the disclosures. In a case reviewed, the listed entity only generally disclosed in its financial statements that “Some of the Group’s transactions and arrangements are with related parties and the effects of these on the basis determined between the parties is reflected in the financial statements”. However, it was not clear from the financial statements which parties were related parties of the listed entity and the nature of the related party relationships and the amounts of transactions and the outstanding balances with those parties.

4. HKAS 36 *Impairment of Assets*

The following disclosures were often omitted:

- Information of the basis on which the cash-generating unit’s (group of units’) recoverable amount has been determined (i.e. value in use or fair value less costs of disposal); and the valuation techniques used to measure fair value less costs of disposal if the unit’s (group of units’) recoverable amount is based on fair value less costs of disposal (HKAS 36 paragraphs 134(c) and (e));
- The recoverable amount of the assets for which an impairment loss has been recognized (HKAS 36 paragraph 130(e)); and
- The events and circumstances that led to the recognition or reversal of the impairment loss (HKAS 36 paragraph 130(a)).

5. HKFRS 3 (Revised) *Business Combinations*

The following disclosure was omitted:

- Information regarding the nature and financial effect of a business combination that occurs after the end of the reporting period but before the financial statements were authorized for issue (HKFRS 3 (Revised) paragraph 59(b)).

6. HKFRS 7 *Financial Instruments: Disclosures*

The following disclosures were often omitted:

- Disclosure of each category of financial assets and financial liabilities as defined in HKAS 39 (HKFRS 9 after 1 January 2018) in the statement of financial position or in the notes (HKFRS 7 paragraph 8);
- Information about (1) the market for the financial instruments; and (2) whether and how the entity intends to dispose of the financial instruments (HKFRS 7 paragraphs 30(c) and (d));

- Information about the credit risk arising from financial instruments (HKFRS 7 paragraphs 32 and 34);
- By class of financial instruments, the amount best represents the entity's maximum exposure to credit risk of its loan and interest receivables at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with HKAS 32) (HKFRS 7 paragraph 36(a)); and
- A maturity analysis for all non-derivative financial liabilities (e.g. long term borrowings) that shows the remaining contractual maturities (HKFRS 7 paragraph 39(a)).

HKFRS 7 has been substantially revised to match the new classification and measurement requirements of HKFRS 9 and to require more information to be disclosed about the entity's exposure to credit risk. Care should be taken when preparing financial statements for the first year of adoption of HKFRS 9 to refer to the updated requirements in HKFRS 7.

Also, as required by HKFRS 7 paragraph 7, an entity shall disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance. In some examples where the conversion price of the convertible bonds issued by the listed entity was subject to adjustments, we found that some of those bonds were considered to have met the "fixed-for-fixed" notion under HKAS 32 and some not, depending on the nature of the "adjustments", e.g. whether those adjustments were anti-dilution provisions for protecting the economic rights of bondholders when certain events occur. When the adjustment clauses are the reason why the bonds failed to meet the "fixed-for-fixed" notion, sufficient disclosures of the nature of the "adjustments" of the convertible bonds and management's consideration of the impact of the adjustments on the classification of the convertible bonds should be provided to assist users of the financial statements to better understand the convertible bonds issued.

7. HKFRS 8 *Operating Segments*

The following disclosures were often omitted:

- The identity of segment or segments reporting the revenues if revenues from transactions with a single external customer amount to 10% or more of the reporting entity's revenue (HKFRS 8 paragraph 34);
- The entity-wide disclosures, e.g. information about geographical areas (HKFRS 8 paragraphs 33(a) and (b)); and
- The measure of profit or loss for each reportable segment and also that of total assets and liabilities for each reportable segment if such amounts are regularly provided to the chief operating decision maker (HKFRS 8 paragraph 23).

8. HKFRS 12 *Disclosure of Interests in Other Entities*

The following disclosure was often omitted:

- Information about significant judgments and assumptions that the reporting entity made in determining the type of joint arrangement when the arrangement has been structured through a separate vehicle (HKFRS 12 paragraph 7(c)).

9. HKFRS 13 *Fair Value Measurement*

The following disclosure was often omitted:

- Information required by HKFRS 13 paragraph 93, e.g.
 - for recurring and non-recurring fair value measurements, the level of the fair value hierarchy within which the fair value measurements are categorized in their entirety (Level 1, 2 or 3) (HKFRS 13 paragraph 93(b)); and
 - for fair value measurements categorized within Level 3 of the fair value hierarchy,
 - (i) quantitative information about the significant unobservable inputs used in the fair value measurement (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)).

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 June and one in October 2018, which drew a combined total of around 540 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 December 2018.
- The Director of the QAD ("the DQA") was invited by the Society of Chinese Accountants and Auditors to present in a seminar in October 2018 on the same topics covered in the Quality Assurance Forum. The seminar attracted over 200 attendees.
- The DQA participated in the practice review session of the 2018 SMP Symposium in November 2018 which attracted approximately 350 attendees.
- The QAD issued a number of publications including an annual report and alerts covering topics such as key issues identified from practice reviews; monitoring of AML compliance; and disciplinary actions arising from practice review complaints.

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 2018

Name	Position	Company
Ms. BROWN, Melissa	Chairman	Daobridge Capital
Mr. TAM Wing Pong	Deputy Chairman	Retired
Mr. CHAN, Kam Wing, Clement	Member	BDO Limited
Ms. CHUNG, Lai Ling	Member	Gov't of HKSAR
Mr. HO, Chiu Ping, Dennis	Member	PricewaterhouseCoopers
Miss KWAN, Angelina	Member	Hong Kong Exchanges and Clearing Limited
Ms. LAU, Wai Yin, Susanna	Member	Securities and Future Commission
Mr. POGSON, Timothy Keith	Member	Ernst & Young
Mr. YIH, Lai Tak, Dieter, JP (Appointed 1 February 2018)	Member	Kwok Yih & Chan

Members of the Practice Review Committee in 2018

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 (Appointed 1 February 2018)	Member	Graham H.Y. Chan & Co.
Mr. CHAN, Shu Kin, Albert	Member	Ting Ho Kwan & Chan
Mr. CHAN, Tze Kit	Member	Grant Thornton Hong Kong Limited
Mr. KWOK, Kin Leung (Appointed 1 February 2018)	Member	HLB Hodgson Impey Cheng Limited
Mr. LIU, Eugene	Member	RSM Hong Kong / RSM Nelson Wheeler
Mr. LO, Charbon	Member	CCIF CPA Limited / Crowe (HK) CPA Limited
Mr. NG, Kam Wah, Webster (Appointed 1 February 2018)	Member	Webster Ng & Co.
Ms. NG, Shun Yin	Member	KPMG
Mr. OR, Ming Chiu	Member	Mazars CPA Limited
Mr. PANG, Wai Hang	Member	SHINEWING (HK) CPA Limited
Ms. TSUI, Maria Yuk Hung (Appointed 1 February 2018)	Member	PricewaterhouseCoopers
Mr. WONG, Ho Yuen, Gary	Member	Confucius International CPA Limited

Members of the Professional Standards Monitoring Expert Panel in 2018

Name	Position	Company
Mr. HEBDITCH, Paul Donald	Member	Ernst & Young
Miss 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 (Appointed 1 February 2018)	Member	Deloitte Touche Tohmatsu
Ms. MORLEY, Catherine Susanna	Member	KPMG
Ms. NG, Wai Ying (Appointed 1 February 2018)	Member	PricewaterhouseCoopers
Mr. ONG, Wei Dong	Member	Hong Kong Exchanges and Clearing Limited
Mr. PANG, Wai Hang	Member	SHINEWING (HK) CPA Limited
Mr. STEVENSON, James Gary	Member	RSM Hong Kong

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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