Auditing and Assurance in Hong Kong

6th Edition

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Dr. Peter Lau is Associate Dean of the School of Business at the Hong Kong Baptist University (HKBU), where he has been a faculty member since 1987. He is an Independent Non-executive Director of Hanison Construction Holdings Limited, a publicly-listed entity on the Stock Exchange of Hong Kong. He received a Bachelor of Commerce (summa cum laude) in accounting from Saint Mary's University, an MBA from Dalhousie University, and a Ph.D. in accounting from the Chinese University of Hong Kong. Dr. Lau is also a Chartered Accountant (Canada), a Certified Management Accountant (Canada), a Chartered Professional Accountant (Canada), a Certified Tax Adviser (Hong Kong), a Fellow of the Hong Kong Institute of Certified Public Accountants, and an Associate of the Taxation Institute of Hong Kong.

Dr. Lau has more than 34 years of experience in teaching both graduate and undergraduate degree courses and conducting workshops, revision courses and examination assistance seminars for various auditing papers of the Association of Chartered Certified Accountants (ACCA) and HKICPA examinations. He conducted Final Examination (FE) revision courses and marked the FE of HKICPA's Qualification Programme for many years. He has been serving, or previously served, as the external examiner for various accounting programmes of City University of Hong Kong, the Open University of Hong Kong, the United International College of the Beijing Normal University and HKBU (UIC), and the University of Hong Kong. He was also an examiner of Module C of HKICPA's Qualification Programme. Dr. Lau has published over 30 journal articles and he is the co-author of Hong Kong Auditing, Intermediate Financial Reporting: An IFRS Perspective, *and* Financial Accounting — International Financial Reporting Standards.

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Mr. Nelson Lam is Adjunct Professor of the School of Business at HKBU, a practicing accountant with his own professional firm and consulting firm, and Executive Chairman at Accountancy Caring Alliance in Hong Kong. He is enthusiastic in serving the community and the accounting profession, in particular in auditing and financial reporting-related projects, including over 600 consultancy projects, seminars and conferences relating to auditing and financial reporting standards in Hong Kong and other Asian cities. The website of his firm, www.NelsonCPA.com.hk/training.htm, contains more than 500 sets of his public presentations and publications for free public download. He is also the co-author of several auditing and financial reporting books, including Financial Accounting — International Financial Reporting Standards, Intermediate Financial Reporting: An IFRS Perspective, *and* Advanced Financial Reporting: An IFRS Perspective.

In addition to holding an MSc in finance from the Chinese University of Hong Kong, an MBA from the Hong Kong University of Science and Technology, and a BBA (Hons) in accounting from HKBU, Nelson is also a CFA Charterholder; a CPA in Australia, Hong Kong, and the US; a fellow member of ACCA; and a Chartered Accountant in the UK. He has received numerous awards for his contributions to professional accountancy examinations and won a championship in an accounting case competition with entries from professors from renowned universities. To enhance the accounting and finance knowledge of the public, he acted as a weekly columnist in a periodical in analyzing the financial statements of listed entities for several years.

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Preface

Purpose and Features of the Book

Auditing and Assurance in Hong Kong (6th Edition) explains the practices of auditing and non-auditing engagements using the most updated International and Hong Kong Auditing Standards.

Key Features

- Coverage of the latest auditing and assurance standards by updating with all new HKSQMs issued in April 2021 (to align with the International Standards on Quality Management finalized and issued in December 2020) and other revised HKSAs, including HKSA 220 (Revised), HKSA 315 (Revised 2019), HKSA 540 (Revised), HKSRS 4400 (Revised) and the relevant conforming amendments
- Coverage of the latest standards on forming an opinion and reporting on financial statements, modifications to the opinion in the independent auditor's report, communicating key audit matters in the independent auditor's report, the auditor's responsibilities relating to other information, assurance engagements other than audits or reviews of historical financial information, accountants' reports on historical financial information in investment circulars, and reporting on profit forecasts, statement of sufficiency of working capital and statement of indebtedness
- Coverage of the Companies Ordinance (Chapter 622)
- Numerous illustrative examples, figures and diagrams
- Tailor-made illustrative flow charts incorporated to help the readers easily understand the complicated requirements of the professional standards
- Real-life cases sourced from companies listed on the Hong Kong Stock Exchange Limited
- Inclusion of recent QP and ACCA exam questions

Structure of the Book

The 54 chapters of this book are structured into the following eight parts:

Part I: Introduction to Auditing and Assurance (Chapter 1) provides an overview of auditing, especially on how auditing is different from accounting and why there is a great demand for auditing.

Part II: The Legal Framework of Auditing (Chapters 2 – 4) discusses independent auditors' professional liability, their responsibility in relation to fraud and their role in the prevention, detection and reporting of fraud, and the relevant provisions in relation to independent auditors under the Hong Kong Companies Ordinance.

Part III: The Professional Framework of Auditing and Assurance (Chapters 5 – 11) briefly describes auditing and assurance standards as well as the relevance of financial reporting standards. This part also presents the latest Code of Professional Ethics and covers the topics of terms of engagement, quality management and practice review.

Part IV: The Audit Process (Chapters 12 – 29) provides a review of the whole audit process from planning, risk assessment, the auditor's response to assessed risks to the issuance of the auditor's report. This part also provides a comprehensive coverage of the audit of major accounting cycles and selected items of the statement of financial position, including financial instruments.

Part V: The Reporting Framework of Auditing (Chapters 30 – 35) discusses audit reporting and related issues on subsequent events, going concern, opening balances, comparatives, and communication with those charged with governance.

Part VI: Special Audit Situations (Chapters 36 – 41) covers the audit of group financial statements, the first audit engagement, the audit of small companies, the audit of summary financial statements, the audit of special purpose financial statements, and the audit of a single financial statement or of a specific element, account or item of a financial statement.

Part VII: Special Audit Topics (Chapters 42 – 50) examines the audit of accounting estimates and related disclosures, the auditor's responsibilities relating to other information, related parties, consideration of laws and regulations, using the work of an auditor's expert, service organizations and outsourcing, using the work of internal auditors, corporate governance and audit committees.

Part VIII: Non-Audit Engagements (Chapters 51 – 54) discusses compilation and agreed-upon procedures engagements, review and other assurance engagements, prospectus reports and letters, and report on the compilation of pro forma financial information included in a prospectus.

For Practitioners

Practitioners will find the concepts and explanations in this book useful in their daily work, and they can use the book as a guide in performing various audit and non-audit engagements. The examples and real-life cases from various sources should be a rich database for them to use for practical guidance and reference.

For Academics

Professors and lecturers teaching auditing and assurance should find this a good textbook for their undergraduate and postgraduate auditing courses. Each chapter of this book can serve as a single topic, and the examples and real-life cases can enhance their sharing and presentation to be more practical and livelier, stimulating students' interest.

Many review questions and case studies are incorporated in this book for students' class discussion, homework and practice exercises. A supplementary guide will also be provided to professors and lecturers using this book; this guide will contain answers to all case studies. Moreover, PowerPoint presentations for each chapter of the book have been created and are available to professors and lecturers.

For Students

Students learning auditing in universities or taking professional examinations offered by professional accounting institutions, for example, ACCA and HKICPA, should consider this book as a good textbook and reference for their understanding of auditing to help them pass their professional examinations. The review questions and case studies can help them practice and understand the concepts and examination requirements. In addition, questions from past professional examinations are adapted and included in each chapter for students' practice and understanding.

Final Remarks and Acknowledgements

We have accumulated cases on using, practicing and teaching auditing and related topics for many years. For example, the website of Nelson Lam's firm (http://www.NelsonCPA.com.hk/training.htm) is uploaded with many sets of PowerPoint slides in PDF format, which are based on Nelson's public presentations in recent years and are available for free public download. With a solid background and hands-on experience in the academic, practical and professional arenas, we understand the demands, interests and limitations of academics, practitioners, students and examiners of professional examinations. We have written this book with reference to these considerations.

We are grateful to the Association of Chartered Certified Accountants, the Canadian Institute of Chartered Accountants, and the Hong Kong Institute of Certified Public Accountants for permission to use (or to adapt) selected questions from their examinations. These questions bear the notations ACCA, CICA, and HKICPA respectively. We appreciate the enormous assistance, support, time and efforts of many parties. Last but not least, Peter Lau would like to thank his wife Lydia and his children Stanley and Shirley for their love and support, and Nelson Lam would like to thank his wife Stephanie and his parents for their love and support.

Peter Lau and Nelson Lam

2021

I

Introduction to Auditing and Assurance

6. Part 1 includes complying with the code, the fundamental principles and the conceptual framework and is applicable to all professional accountants. (see Table 7.1)

Complying with the Code (Section 100)

7. A professional accountant shall comply with the Code. There are circumstances where laws or regulations preclude a professional accountant from complying with certain parts of the Code, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code. Some jurisdictions might have provisions that differ from or go beyond those set out in the Code. Accountants in those jurisdictions need to be aware of those differences and comply with the more stringent provisions unless prohibited by law or regulation.

8. A professional accountant who identifies a breach of a provision of the Code shall evaluate the significance of the breach and its impact on the accountant's ability to comply with the fundamental principles. The accountant shall also take whatever actions might be available, as soon as possible, to address the consequences of the breach satisfactorily, and determine whether to report the breach to the relevant parties.

The Fundamental Principles (Section 110)

9. A professional accountant shall comply with each of the five fundamental principles of ethics for professional accountants: integrity, objectivity, professional competence and due care, confidentiality, and professional behavior.

10. **Integrity (Subsection 111)**

    a. A professional accountant shall comply with the principle of **integrity**, which requires an accountant to be straightforward and honest in professional and business relationships.

    b. A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:

       i. Contains a materially false or misleading statement;

       ii. Contains statements or information provided recklessly; or

       iii. Omits or obscures required information where such omission or obscurity would be misleading.

    c. A professional accountant will not be in breach of paragraph 10b if the professional accountant provides a modified report in respect of a matter contained in paragraph 10b.

    d. When a professional accountant becomes aware of having been associated with information described in paragraph 10b, the accountant shall take steps to be disassociated from that information.

11. **Objectivity (Subsection 112)**

    a. A professional accountant shall comply with the principle of **objectivity**, which requires an accountant to exercise professional or business judgment without being compromised by bias, conflict of interest, or the undue influence of, or undue reliance on, individual, organizations, technology or other factors.

51. Factors that are relevant in evaluating the level of such a threat include:
    a. The significance of the financial interest.
    b. Policies and procedures for a committee independent of management to determine the level or form of senior management remuneration.
    c. In accordance with any internal policies, disclosure to those charged with governance of all relevant interests and any plans to exercise entitlements or trade in relevant shares.
    d. Internal and external audit procedures that are specific to address issues that give rise to the financial interest.

Inducements, Including Gifts and Hospitality (Section 250)

52. Offering or accepting inducements might create a self-interest, familiarity or intimidation threat to compliance with the fundamental principles, particularly the principles of integrity, objectivity and professional behavior.

53. An inducement is an object, situation, or action that is used as a means to influence another individual's behavior, but not necessarily with the intent to improperly influence that individual's behavior. An inducement can take many different forms including gifts, hospitality, entertainment, political or charitable donations, appeals to friendship and loyalty, employment or other commercial opportunities, and preferential treatment, rights or privileges.

54. **Inducements Prohibited by Laws and Regulations**
    a. In many jurisdictions, there are laws and regulations, such as those related to bribery and corruption, that prohibit the offering or accepting of inducements in certain circumstances. The professional accountant in business shall obtain an understanding of relevant laws and regulations and comply with them when the accountant encounters such circumstances.
    b. There are provisions under the Prevention of Bribery Ordinance (POBO) (Cap. 201) governing acceptance of any advantage (e.g. gift, loan, fee, commission, employment, service, favor) by someone who is in an agent-principal relationship with another person. For example, if an agent receives an advantage from another for doing something or showing favor to another in relation to the affairs or business of the agent's principal (who may be the agent's employer or in some other relationships with the agent which involve trust and confidence), the permission of the principal should be obtained first before receiving the advantage in order to avoid the risk of contravening the POBO.
    c. The same principle applies to someone who is offering an advantage to another person who is in an agent-principal relationship with some other person: before offering an advantage, the payer should ensure that the agent has obtained permission from his principal for receiving the advantage. Whether an agent-principal relationship exists in any given situation depends on the facts of each case. Members should consult their own legal advisers as and when necessary.
    d. To deter corrupt approaches and set out clear probity standards for all levels of staff, it is advisable for every company to lay down the company's policy and rules governing acceptance and offering of advantage and entertainment in a Code of Conduct which should cover both directors and staff. The sample code of conduct provided by the ICAC for the private sector may be used as a reference.

c. **Responsibilities of Senior Professional Accountants in Business**

i. Senior professional accountants in business ("senior professional accountants") are directors, officers or senior employees able to exert significant influence over, and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources.

ii. There is a greater expectation for such individuals to take whatever action is appropriate in the public interest to respond to non-compliance or suspected non-compliance than other professional accountants within the employing organization.

iii. If, in the course of carrying out professional activities, a senior professional accountant becomes aware of information concerning non-compliance or suspected non-compliance, the accountant shall obtain an understanding of the matter. This understanding shall include:

(1) The nature of the non-compliance or suspected non-compliance and the circumstances in which it has occurred or might occur;

(2) The application of the relevant laws and regulations to the circumstances; and

(3) An assessment of the potential consequences to the employing organization, investors, creditors, employees or the wider public.

iv. If the senior professional accountant identifies or suspects that non-compliance has occurred or might occur, the accountant shall, subject to paragraph 62b (i) above, discuss the matter with the accountant's immediate superior, if any. If the accountant's immediate superior appears to be involved in the matter, the accountant shall discuss the matter with the next higher level of authority within the employing organization.

v. The senior professional accountant shall also take appropriate steps to:

(1) Have the matter communicated to those charged with governance;

(2) Comply with applicable laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority;

(3) Have the consequences of the non-compliance or suspected non-compliance rectified, remediated or mitigated;

(4) Reduce the risk of re-occurrence; and

(5) Seek to deter the commission of the non-compliance if it has not yet occurred.

vi. In addition to responding to the matter in accordance with the provisions of this section, the senior professional accountant shall determine whether disclosure of the matter to the employing organization's external auditor, if any, is needed.

vii. The senior professional accountant shall assess the appropriateness of the response of the accountant's superiors, if any, and those charged with governance.

viii. In light of the response of the senior professional accountant's superiors, if any, and those charged with governance, the accountant shall determine if further action is needed in the public interest.

iii. If the professional accountant becomes aware of an inducement offered with actual or perceived intent to improperly influence behavior, threats to compliance with the fundamental principles might still be created even if the requirements in (i) and (ii) are met. Examples of actions that might be safeguards to address such threats include informing senior management of the firm or those charged with governance of the client regarding the offer and amending or terminating the business relationship with the client.

c. **Inducements with No Intent to Improperly Influence Behavior**

i. Examples of circumstances where offering or accepting such an inducement might create threats even if the professional accountant has concluded there is no actual or perceived intent to improperly influence behavior include:

(1) Self-interest threats. A professional accountant is offered hospitality from the prospective acquirer of a client while providing corporate finance services to the client.

(2) Familiarity threats. A professional accountant regularly takes an existing or prospective client to sporting events.

(3) Intimidation threats. A professional accountant accepts hospitality from a client, the nature of which could be perceived to be inappropriate were it to be publicly disclosed.

ii. Examples of actions that might eliminate threats created by offering or accepting such an inducement include:

(1) Declining or not offering the inducement.

(2) Transferring responsibility for the provision of any professional services to the client to another individual who the professional accountant has no reason to believe would be, or would be perceived to be, improperly influenced when providing the services.

iii. Examples of actions that might be safeguards to address such threats created by offering or accepting such an inducement include:

(1) Being transparent with senior management of the firm or of the client about offering or accepting an inducement.

(2) Registering the inducement in a log monitored by senior management of the firm or another individual responsible for the firm's ethics compliance or maintained by the client.

(3) Having an appropriate reviewer, who is not otherwise involved in providing the professional service, review any work performed or decisions made by the professional accountant with respect to the client from which the accountant accepted the inducement.

(4) Donating the inducement to charity after receipt and appropriately disclosing the donation, for example, to a member of senior management of the firm or the individual who offered the inducement.

(5) Reimbursing the cost of the inducement, such as hospitality, received.

(6) As soon as possible, returning the inducement, such as a gift, after it was initially accepted.

ii. The accountant is engaged to perform an audit of the component's financial statements for purposes other than the group audit, for example, a statutory audit.

b. Where the group engagement partner becomes aware of non-compliance or suspected non-compliance in the course of an audit of group financial statements, the group engagement partner shall consider whether the matter might be relevant to one or more components:

   i. Whose financial information is subject to work for purposes of the audit of the group financial statements; or

   ii. Whose financial statements are subject to audit for purposes other than the group audit, for example, a statutory audit.

c. If the non-compliance or suspected non-compliance might be relevant to one or more of the components specified in paragraph b above, the group engagement partner shall take steps to have the matter communicated to those performing work at the components, unless prohibited from doing so by law or regulation. If necessary, the group engagement partner shall arrange for appropriate inquiries to be made (either of management or from publicly available information) as to whether the relevant component(s) specified in paragraph b(ii) above is subject to audit and, if so, to ascertain to the extent practicable the identity of the auditor.

116. **Determining Whether Further Action Is Needed**

a. The professional accountant shall assess the appropriateness of the response of management and, where applicable, those charged with governance.

b. In light of the response of management and, where applicable, those charged with governance, the professional accountant shall determine if further action is needed in the public interest.

c. The professional accountant shall exercise professional judgment in determining the need for, and nature and extent of, further action. In making this determination, the accountant shall take into account whether a reasonable and informed third party would be likely to conclude that the accountant has acted appropriately in the public interest.

d. Further action that the professional accountant might take include disclosing the matter to an appropriate authority even when there is no legal or regulatory requirement to do so and/or withdrawing from the engagement and the professional relationship where permitted by law or regulation.

e. Withdrawing from the engagement and the professional relationship is not a substitute for taking other actions that might be needed to achieve the professional accountant's objectives under this section.

f. Where the professional accountant has withdrawn from the professional relationship, the accountant shall, on request by the proposed accountant pursuant to paragraph 86f, provide all relevant facts and other information concerning the identified or suspected non-compliance to the proposed accountant. The predecessor accountant shall do so, even in the circumstances addressed in paragraph 86f (ii) where the client fails or refuses to grant the predecessor accountant permission to discuss the client's affairs with the proposed accountant, unless prohibited by law or regulation.

Fees (Section 410)

154. The nature and level of fees or other types of remuneration might create a self-interest or intimidation threat.

155. **Fees — Relative Size**

   a. When the total fees generated from an audit client by the firm expressing the audit opinion represent a large proportion of the total fees of that firm, the dependence on that client and concern about losing the client create a self-interest or intimidation threat. Example of a safeguard: Increasing the client base in the firm to reduce dependence on the audit client.

   b. A self-interest or intimidation threat is also created when the fees generated by a firm from an audit client represent a large proportion of the revenue of one partner or one office of the firm. Examples of safeguards:

      i. Increasing the client base of the partner or the office to reduce dependence on the audit client.

      ii. Having an appropriate reviewer who did not take part in the audit engagement review the work.

   c. Where an audit client is a public interest entity and, for two consecutive years:

      i. The total fees from the client and its related entities represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client, the firm shall:

         (1) Disclose to those charged with governance of the audit client the fact that the total of such fees represents more than 15% of the total fees received by the firm; and

         (2) Discuss whether either a pre-issuance review or a post-issuance review might be a safeguard to address the threat, and if so, apply it.

      ii. When the total fees significantly exceed 15%, the firm shall determine whether the level of the threat is such that a post-issuance review would not reduce the threat to an acceptable level. If so, the firm shall have a pre-issuance review performed.

      iii. If the fees described in (i) continue to exceed 15%, the firm shall each year disclose to and discuss with those charged with governance the significant fees matters and comply with (i) and (ii).

156. **Fees — Overdue**

   a. A self-interest threat might be created if a significant part of fees is not paid before the audit report for the following year is issued. Examples of safeguards: Obtaining partial payment of overdue fees and having an appropriate reviewer who did not take part in the audit engagement review the work performed.

   b. When a significant part of fees due from an audit client remains unpaid for a long time, the firm shall determine whether the overdue fees might be equivalent to a loan to the client and whether it is appropriate for the firm to be re-appointed or continue the audit engagement.

175. **Financial Interests — Other Individuals**

a. A self-interest threat might be created if an audit team member knows that a financial interest in the audit client is held by individuals such as:

i. Partners and professional employees of the firm or network firm, apart from those who are specifically not permitted to hold such financial interests as described in paragraph 168a, or their immediate family members.

ii. Individuals with a close personal relationship with an audit team member.

b. An example of an action that might eliminate such threat is removing the audit team member with the personal relationship from the audit team.

c. Examples of safeguards: Excluding the audit team member from any significant decision-making concerning the audit engagement and having an appropriate reviewer review the work of the audit team member.

176. A self-interest threat might be created if a retirement benefit plan of a firm or a network firm holds a direct or material indirect financial interest in an audit client.

Loans and Guarantees (Section 511)

177. A loan or a guarantee of a loan with an audit client might create a self-interest threat.

178. **Loans and Guarantees with an Audit Client**. A firm, a network firm, an audit team member, or any of that individual's immediate family shall not make or guarantee a loan to an audit client unless the loan or guarantee is immaterial to the firm, the network firm or the individual making the loan or guarantee, as applicable; and the client.

179. **Loans and Guarantees with an Audit Client that Is a Bank or Similar Institution**

a. A firm, a network firm, an audit team member, or any of that individual's immediate family shall not accept a loan, or a guarantee of a loan, from an audit client that is a bank or a similar institution unless the loan or guarantee is made under normal lending procedures, terms and conditions.

b. Examples of loans include mortgages, bank overdrafts, car loans, and credit card balances.

c. Even under normal lending procedures, terms and conditions, the loan might create a self-interest threat if it is material to the audit client or firm receiving the loan.

d. An example of a safeguard is having the work reviewed by an appropriate reviewer, who is not an audit team member, from a network firm that is not a beneficiary of the loan.

e. A firm, a network firm, an audit team member, or any of that individual's immediate family shall not have **deposits or a brokerage account** with an audit client that is a bank, broker or similar institution, unless the deposit or account is held under normal commercial terms.

180. **Loans and Guarantees with an Audit Client that Is Not a Bank or Similar Institution**. A firm, a network firm, an audit team member, or any of that individual's immediate family shall not accept a loan from, or have a borrowing guaranteed by, an audit client that is not a bank or similar institution, unless the loan or guarantee is immaterial to the firm, the network firm, or the individual receiving the loan or guarantee, as applicable and the client.

- Legislation and regulation that significantly affect the entity's operations, for example, labor laws and regulations.
- Taxation legislation and regulations.
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restriction policies.
- Environmental requirements affecting the industry and the entity's business.

- Other external factors
  - General economic conditions.
  - Interest rates and availability of financing.
  - Inflation or currency revaluation.

44. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation.

Example 15.16

A property constructor is involved in the construction industry and the contracts for the services usually last for 3 to 5 years. Revenue is generated and costs are incurred during the term of the contract and accounted for by using the accounting practices applicable to construction contracts or long-term contracts.

The business in long-term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement. In such cases, it is important that the engagement team includes members with sufficient relevant knowledge and experience.

45. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment and any changes thereto.

MEASURES USED TO ASSESS THE ENTITY'S FINANCIAL PERFORMANCE

46. An auditor is required to perform risk assessment procedures to obtain an understanding of the entity's **measures used, internally and externally, to assess the entity's financial performance** (HKSA 315.19).

47. An understanding of the entity's measures used by the management to assess its financial performance assists the auditor in considering whether such measures create pressures on the entity to achieve performance targets. These pressures may motivate management to take actions that increase the susceptibility to misstatement due to management bias or fraud.

52. The definition of applicable financial reporting framework is set out in **HKSA 200** (see Chapter 12). In Hong Kong, an applicable financial reporting framework is the accounting principles generally accepted in Hong Kong, including the Hong Kong Financial Reporting Standards, the disclosure requirements under the Hong Kong Companies Ordinance, and, in case of a listed company, the disclosure requirements of Hong Kong Listing Rules. In practice, other frameworks may also be applicable, including International Financial Reporting Standards or other comprehensive basis of accounting.

53. The auditor is also required to evaluate whether the entity's accounting policies are appropriate and consistent with the applicable financial reporting framework (HKSA 315.20).

54. **HKSA 315 (Revised 2019)** has separated and enhanced the requirement to obtain an understanding of the applicable financial reporting framework in order to encourage an increased focus of the auditor on the entity's financial reporting requirements. Because it is the application of the framework in the context of the nature and circumstances of the entity that gives rise to potential risks of misstatement.

Example 15.19

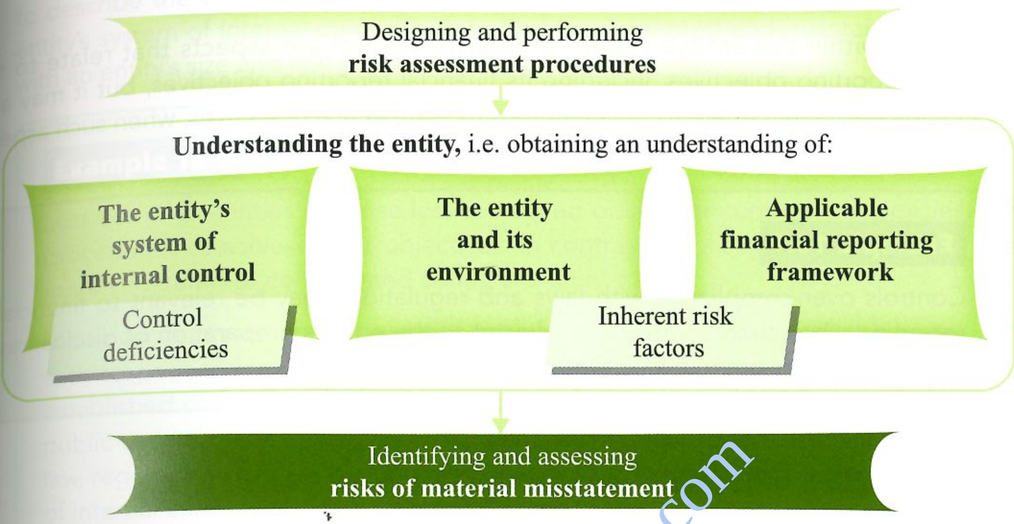
Matters that the auditor may consider when obtaining an understanding of the entity's applicable financial reporting framework, and how it applies in the context of the nature and circumstances of the entity and its environment include:

- The entity's financial reporting practices in terms of the applicable financial reporting framework, such as:
  - Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).
  - Revenue recognition.
  - Accounting for financial instruments, including related credit losses.
  - Foreign currency assets, liabilities and transactions.
  - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for cryptocurrency).
- An understanding of the entity's selection and application of accounting policies, including any changes thereto as well as the reasons therefore, may encompass such matters as:
  - The methods the entity uses to recognize, measure, present and disclose significant and unusual transactions.
  - The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
  - Changes in the environment, such as changes in the applicable financial reporting framework or tax reforms that may necessitate a change in the entity's accounting policies.
  - Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt, or comply with, such requirements.

Review Questions with Answers

1. State the objective of the auditor in **HKSA 315**. (5)
2. What is the use of obtaining an understanding of the client's entity? (8 - 9)
3. What is the auditor's primary consideration in judging whether the understanding of the entity and its environment is sufficient? (11)
4. What are risk assessment procedures? (12)
5. What kinds of risk assessment procedures shall be performed by an auditor to obtain an understanding of the entity and its environment? (15)
6. State the purpose and use of analytical procedures. (20 - 21)
7. What are the purposes of discussing with the engagement team the susceptibility of the entity's financial statements to material misstatement? (26)
8. Which aspects shall be understood by the auditor when the auditor obtains an understanding of the entity and its environment? (29 - 30)
9. What is the business model of an entity and its implication on the financial statements? (36 - 37)
10. What is a business risk? (38)
11. What is the implication of business risks on the financial statements? (38 - 42)
12. What kinds of factors can be considered when the auditor obtains an understanding of the industry, regulatory and other external factors? (43 - 45)
13. Why does the auditor consider the measures used to assess the entity's financial performance? (46 - 50)
14. Why is there a separate focus of an understanding of the entity's applicable financial reporting framework? (54)
15. What are inherent risk factors and their usage? (56 - 57)
16. What kinds of audit documentation are required by **HKSA 315**? (60)

Figure 16.2: Risk Assessment and Understanding of the Entity and Its Environment, the Applicable Financial Reporting Framework and the Entity's System of Internal Control



CHARACTERISTICS OF A SYSTEM OF INTERNAL CONTROL

4. The auditor's understanding of the entity's system of internal control is obtained through performing risk assessment procedures as required by **HKSA 315**. For the purposes of the HKSAs, an entity's system of internal control defined in **HKSA 315** consists of five inter-related components. An auditor is required to perform risk assessment procedures to understand and evaluate each of the components of the system of internal control.

System of internal control is defined as:

- The system designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to:
  - Reliability of financial reporting,
  - Effectiveness and efficiency of operations, and
  - Compliance with applicable laws and regulations.
- For the purposes of the HKSAs, the system of internal control consists of five inter-related components:
  a. Control environment;
  b. The entity's risk assessment process;
  c. The entity's process to monitor the system of internal control;
  d. The information system and communication; and
  e. Control activities.

5. The entity's system of internal control may be reflected in policy and procedures manuals, systems and forms, and the information embedded therein, and is effected by people. The entity's system of internal control is implemented by management, those charged with governance and other personnel based on the structure of the entity.

- Reviewing the internal audit function's audit plan for the period, if any, and
- Discussing that plan with the appropriate individuals within the function.

This understanding, together with the information obtained from the auditor's inquiries, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, **HKSA 610** applies (see Chapter 48).

42. **Understanding the sources of information**. Management's monitoring activities may use information in communications from external parties such as customer complaints or regulator comments that may indicate problems or highlight areas in need of improvement.

The auditor's understanding of the sources of information used by the entity in monitoring the entity's system of internal control, including whether the information used is relevant and reliable, assists the auditor in evaluating whether the entity's process to monitor the entity's system of internal control is appropriate.

If management assumes that information used for monitoring is relevant and reliable without having a basis for that assumption, errors that may exist in the information could potentially lead management to draw incorrect conclusions from its monitoring activities.

43. **Evaluating the entity's process to monitor the system of internal control**. The auditor's evaluation about how the entity undertakes ongoing and separate evaluations for monitoring the effectiveness of controls assists the auditor in:

- Understanding whether the other components of the entity's system of internal control are present and functioning;
- Understanding the other components of the entity's system of internal control; and
- Identifying and assessing financial statement level and assertion level risks of material misstatement.

UNDERSTANDING AND EVALUATING THE INFORMATION SYSTEM AND COMMUNICATION

44. The auditor is required to obtain an understanding of the entity's **information system and communication** relevant to the preparation of the financial statements, through performing risk assessment procedures, by:

a. **Understanding** the entity's information processing activities, including its data and information, the resources to be used in such activities and the policies that define, for **significant classes of transactions, account balances and disclosures**:

i. How information flows through the entity's information system, including how:

(1) Transactions are initiated, and how information about them is recorded, processed, corrected as necessary, incorporated in the general ledger and reported in the financial statements; and

- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop accounting estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
  - Assumptions developed internally that may affect an asset's useful life; or
  - Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions. Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.

55. **Understanding the information technology (IT) in the information system**. The auditor's understanding of the information system includes the IT environment relevant to the flows of transactions and processing of information in the entity's information system because the entity's use of IT applications or other aspects in the IT environment may give rise to **risks arising from the use of IT**. The understanding of the entity's business model and how it integrates the use of IT may also provide useful context to the nature and extent of IT expected in the information system.

Risks arising from the use of information technology (IT) are defined as:

- Susceptibility of information processing controls to ineffective design or operation, or risks to the integrity of information (i.e. the completeness, accuracy and validity of transactions and other information) in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.

56. **Understanding the communication**. In larger, more complex entities, information the auditor may consider when understanding the entity's communication may come from policy manuals and financial reporting manuals. In less complex entities, communication may be less structured due to fewer levels of responsibility and management's greater visibility and availability. Regardless of the size of the entity, open communication channels facilitate the reporting of exceptions and acting on them.

57. **Evaluating the information system and communication**. The auditor's evaluation of whether the entity's information system and communication appropriately supports the preparation of the financial statements is based on the understanding obtained as required by **HKSA 315**.

62. Controls in the control activities component for less complex entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, in less complex entities, more controls may be directly applied by management.

It may be less practicable to establish segregation of duties in less complex entities that have fewer employees. However, in an owner-managed entity, the owner-manager may be able to exercise more effective oversight through direct involvement than in a larger entity, which may compensate for the generally more limited opportunities for segregation of duties. Although domination of management by a single individual can be a potential control deficiency since there is an opportunity for management override of controls.

63. **Understanding control activities**. The auditor's identification and evaluation of controls in the control activities component is focused on information processing controls, which are controls applied during the processing of information in the entity's information system that directly address risks to the integrity of information, i.e. the completeness, accuracy and validity of transactions and other information.

However, the auditor is not required to identify and evaluate all information processing controls related to the entity's policies that define the flows of transactions and other aspects of the entity's information processing activities for the significant classes of transactions, account balances and disclosures.

64. There may also be direct controls that exist in the first three components of the system of control, i.e. the control environment, the entity's risk assessment process or the entity's process to monitor the system of internal control, which may be identified in accordance with **HKSA 315**.

However, the more indirect the relationship between controls that support other controls and the control that is being considered, the less effective that control may be in preventing, or detecting and correcting, related misstatements.

Example 16.16

A sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the risks of material misstatement relevant to the completeness assertion for sales revenue. Accordingly, it may be less effective in addressing those risks than controls more directly related thereto, such as matching shipping documents with billing documents.

65. **HKSA 315** also requires the auditor to identify and evaluate general information technology (IT) controls for IT applications and other aspects of the IT environment that the auditor has determined to be subject to risks arising from the use of IT, because general IT controls support the continued effective functioning of information processing controls. A general IT control alone is typically not sufficient to address a risk of material misstatement at the assertion level.

2. **HKSA 315 (Revised 2019)** "Identifying and Assessing the Risks of Material Misstatement" (also referred as **HKSA 315**) sets out specific requirements on identifying and assessing the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels through designing and performing risk assessment procedures, which are to obtain an understanding of the entity and its environment, the applicable financial reporting framework, and the entity's system of internal control. Then, the audit evidence obtained provides a basis for designing and implementing responses to the assessed risks of material misstatement.

Chapter 15 explains the requirements on risk assessment procedures and the understanding of the entity and its environment, and the applicable financial reporting framework. Chapter 16 addresses the understanding of the entity's system of internal control. This chapter explains the audit risk from a broader view and then the identification and assessment of risks of material misstatement in an audit process. The requirements added and clarified by **HKSA 315 (Revised 2019)** in respect of determining relevant assertions, assessing inherent risk and other issues are also explained in this chapter.

WHY IS RISK IMPORTANT?

3. In an engagement, no matter whether it is assurance engagement or audit engagement, there is always a risk of inappropriate conclusion being made, including:
   a. An auditor may issue a qualified opinion when in fact the financial statements give a true and fair view (Type I error).
   b. An auditor may issue an unqualified opinion when in fact the subject matter information, such as financial statements, does not give a true and fair view (Type II error) (see Chapter 32 for further discussion).

4. Engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated and, in particular, audit risk refers to the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Elliott and Rogers (1972)[1] argue that audit risk (i.e. committing the Type II error) is more critical to the auditor because the consequence of this error involves:
   a. Litigation,
   b. Possible sanctions placed upon the auditor by the government or other regulatory bodies,
   c. Impaired professional reputation, and
   d. Loss of clients or failure to obtain new clients.

   A serious damage may be created on the auditor and on the audit firm. An auditor, thus, should consider the relationship between risk and the audit process and understand the nature and level of risk they would encounter or handle.

5. "Hong Kong Framework for Assurance Engagements" (Framework) clearly states that the quantity of evidence needed is affected by the risks of the subject matter information, such as the financial statements, being materially misstated, and also by the quality of such evidence (Framework para. 61). In other words, the greater the risk, the more evidence is likely to be required. Simultaneously, the higher the quality, the less evidence may be required. Obtaining more evidence, however, may not compensate for its poor quality.

1 R. K. Elliott and J. R. Rogers, "Relating Statistical Sampling to Audit Objectives", *Journal of Accountancy*, July 1972, pp.46-55.

PERFORMANCE MATERIALITY

26. The auditor is required to determine **performance materiality** for purposes of:

    a. Assessing the risks of material misstatement and
    b. Determining the nature, timing and extent of further audit procedures.

> **Performance materiality**:
>
> - Means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.
> - If applicable, also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

27. Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements.

28. Performance materiality is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole.

    Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure.

29. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by:

    a. The auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and
    b. The nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

> **Example 18.11**
>
> As set out in Examples 18.8 and 18.10, Kimmie CPA Limited is auditing the financial statements of Happy Resources Corporation, which has an estimated profit before tax of $2.7 million. Kimmie, the engagement partner, determines the materiality for the financial statements at $135,000, being 5% of the estimated profit before tax figure, and a lower level of materiality should be set in respect of the transactions between the company and individual family owners at $60,000.

55. **HKSA 240** (see Chapter 3) explains how the implications of a misstatement that is, or may be, the result of fraud ought to be considered in relation to other aspects of the audit, even if the size of the misstatement is not material in relation to the financial statements.

Depending on the circumstances, misstatements in disclosures could also be indicative of fraud, and, for example, may arise from:

a. Misleading disclosures that have resulted from bias in management's judgments; or
b. Extensive duplicative or uninformative disclosures that are intended to obscure a proper understanding of matters in the financial statements.

When considering the implications of misstatements in classes of transactions, account balances and disclosures, the auditor exercises professional skepticism in accordance with **HKSA 200**.

56. The cumulative effect of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements. There are different acceptable approaches to the auditor's evaluation of such uncorrected misstatements on the current period's financial statements. Using the same evaluation approach provides consistency from period to period.

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

57. Unless prohibited by law or regulation, the auditor must communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.

58. The auditor's communication must identify material uncorrected misstatements individually. The auditor is required to request that uncorrected misstatements be corrected; and to communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

59. Where there is a large number of individual immaterial uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the uncorrected misstatements, rather than the details of each individual uncorrected misstatement.

60. **HKSA 260** requires the auditor to communicate with those charged with governance the written representations the auditor is requesting (see Chapter 35). The auditor may discuss with those charged with governance the reasons for, and the implications of, a failure to correct misstatements, having regard to the size and nature of the misstatement judged in the surrounding circumstances, and possible implications in relation to future financial statements.

WRITTEN REPRESENTATION

61. The auditor must request a written representation from management and, where appropriate, those charged with governance regardless of whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items must be included in or attached to the written representation.

Discussion

Comment on the practice management and quality management issues raised by the audit manager's suggestions to improve the audit firm's profitability.

Case Study 7

Angel Limited ("Angel") is an integrated fine jewellery manufacturer and original design provider with a well-established operating history in Hong Kong. Angel is primarily engaged in designing, manufacturing and trading of jewellery products. During the year, Angel was successfully listed on the Hong Kong Stock Exchange. After listing, approximately 65% of its shares are owned by the "An" family. The control environment of Angel is similar to other small and medium-sized entities ("SMEs") where a lot of Angel's activities are controlled by a few family members of the controlling shareholders.

Discussion

Assuming your audit engagement manager has consulted you as to which one of the following methods to determine the materiality of Angel's financial statements is appropriate. Advise and explain to your audit engagement manager which method should be adopted.

a. Total assets (HK$300 million)×0.5% = HK$1.5 million; or
b. Profit before tax (HK$90 million)×5% = HK$4.5 million

(HKICPA adapted)

Case Study 8

Mary Limited is a company listed on the Main Board of The Hong Kong Stock Exchange and is engaged in the manufacturing and trading of garments.

You are the auditor of Mary Limited and are performing audit planning for the year. The following financial information has been extracted from the latest management accounts prepared by management of Mary Limited:

	9 months for the current year (HK$'000)	Last year (HK$'000)
Revenue	1,000,000	2,000,000
Profit before tax from continuing operations	500	10,000
Net current assets / (liabilities)	(200)	2,000
Shareholders' equity	3,000	5,000

Based on the information provided by Mary Limited, the profit before tax from continuing operations for the nine months for the current year includes the following unusual items:

1. Impairment of property, plant and equipment of HK$3 million; and
2. Share-based payment expenses on granting one-off share options to a director of Mary Limited of HK$2 million.

b. Matters related to the IT applications and IT infrastructure:
   i. The type of application (e.g. a commercial application with little or no customization, or a highly-customized or highly-integrated application).
   ii. The complexity of the nature of the IT applications and the underlying IT infrastructure.
   iii. Whether there is third-party hosting or outsourcing of IT.
   iv. Whether the entity is using emerging technologies that affect its financial reporting.

c. Matters related to IT processes:
   i. The personnel involved in maintaining the IT environment.
   ii. The complexity of processes to manage access rights.
   iii. The complexity of the security over the IT environment.
   iv. Whether program changes have been made to the manner in which information is processed, and the extent of such changes during the period.
   v. The extent of change within the IT environment (e.g. new aspects of the IT environment).
   vi. Whether there was a major data conversion during the period and, if so, the nature and significance of the changes made, and how the conversion was undertaken.

15. When entities use **emerging technologies** (e.g. blockchain, robotics or artificial intelligence), the auditor may include such technologies in the identification of IT applications and other aspects of the IT environment that are subject to risks arising from the use of IT. The auditor's responsibilities in relation to IT applications and identified general IT controls remain unchanged.

16. Specific matters that the auditor may consider in understanding the nature of a commercial accounting software package, which may be the single IT application used by a less complex entity in its information system, may include:

    a. The extent to which the software is well established and has a reputation for reliability;
    b. The extent to which it is possible for the entity to modify the source code of the software to include additional modules (i.e. add-ons) to the base software, or to make direct changes to data;
    c. The nature and extent of modifications that have been made to the software; and
    d. The extent to which data related to the preparation of the financial statements can be directly accessed (i.e. direct access to the database without using the IT application) and the volume of data that is processed.

17. Complex IT environments may include highly-customized or highly-integrated IT applications and may therefore require more effort to understand. In other cases, an entity may use internal or external service providers to manage certain aspects of, or IT processes within, its IT environment (e.g. third-party hosting).

(2) Specialized access control software such as on-line monitors that maintain control over menu, authorization table, passwords, files and programs that users are permitted to access.

(3) Physical controls such as the use of key locks on terminal devices, locked computer rooms and inactivity timeouts.

ii. **Control over assignment and maintenance of passwords** to restrict access to authorized users.

iii. **System development and maintenance controls** to ensure that controls essential to on-line applications are included in the system during its development and maintenance.

iv. **Programming controls** to prevent or detect improper changes to computer programs.

v. **Transaction logs** to create an audit trail for each on-line transaction. The source of a transaction (terminal, time and user) and transaction's details are documented.

vi. **Firewalls**.

c. The following **information processing controls** are particularly important to on-line processing.

i. **Pre-processing authorization** for initiating a transaction. For example, the use of a bank card together with a personal identification number before being able to make cash withdrawal through an ATM.

ii. **Terminal device edit**, reasonableness and other validation tests to check the input data and processing results for completeness, accuracy and reasonableness (e.g. sequence, limit, range and reasonableness check).

iii. **Input error reporting** and handling procedures to ensure that all input errors are properly reported, identified and rejected from further processing, corrected and resubmitted for processing in a timely manner.

iv. **Cut-off procedures** to ensure transactions are processed in the proper accounting period, particularly necessary when there is a continuous flow of transactions.

v. **File controls** to ensure correct data files are used for on-line processing.

vi. **Master file controls** to control changes to master files.

vii. **Balancing** to ensure complete and accurate data are transferred to each processing phase. Balancing refers to agree control totals of data being submitted for processing to the computer calculated totals during and after processing.

viii. Control may be established by an **independent function** that generally handles all receiving, processing and distribution functions.

48. **Effects of on-line computer systems on the accounting systems and related internal controls**:

a. The effect depends on the extent of its use in processing accounting applications, the type and significance of financial transactions being processed, and the nature of files and programs used in the applications.

CONSIDERATIONS IN THE USE OF CAATs

10. When planning an audit, the auditor may determine an appropriate combination of manual and CAATs. In determining whether to use CAATs and which CAATs to select, the auditor may consider:

a. **The level of IT knowledge, expertise and experience of the audit team**. The auditor should have sufficient knowledge to plan, execute and use the results of the particular CAAT adopted.

b. **The availability of CAATs and suitable computer facilities and data**.

   i. The auditor may plan to use other IT facilities when the use of CAATs on the client's IT facilities is uneconomical or impractical, or where the auditor cannot exercise sufficient control over the processing of CAATs.

   ii. The auditor needs the co-operation of the client's personnel to provide IT facilities at a convenient time, to assist with such activities as the loading and running of the CAATs on the IT system, and to provide copies of data files in the format required by the auditor.

c. **The impracticability of manual tests**. Where the IT system performs tasks for which no hard copy evidence is available and such procedures are significant to the audit process, it may be impracticable for the auditor to perform tests manually. In addition, it may not be possible for the auditor to perform some audit procedures manually because they rely on complex processing (for example, advanced statistical analysis) or involve amounts of data that would overwhelm any manual procedure. **Lack of hard copy evidence** may occur at different stages in the accounting process:

   i. **Source information may be initiated electronically**, such as by voice activation, electronic data imaging or point of sale electronic funds transfer. Some transactions, such as discounts and interest calculations, may be generated directly by computer programs with no specific authorization of individual transactions.

   ii. A system may **not produce a visible audit trail** providing assurance as to the completeness and accuracy of transactions processed. For example, goods received notes and suppliers' invoices may be matched by a computer program; and automated control, such as checking customer credit limits, may provide hard copy evidence only on an exception basis.

   iii. A system may **not produce hard copy reports**. Moreover, a printed report may contain only summary totals while the computer files retain the supporting details.

d. The **audit effectiveness and efficiency** of using CAATs to obtain and evaluate audit evidence. Some examples are:

   i. It is often efficient to use CAATs to test a large number of transactions or controls over large populations. CAATs can be used to examine all or a greater number of transactions in a computer file than would otherwise be selected.

   ii. In applying analytical procedures, transaction or balance details may be reviewed and reports of unusual items may be printed more efficiently by using CAATs instead of manual methods.

   iii. The use of CAATs may make substantive procedures more efficient than placing reliance on computer controls and related tests of control procedures.

7. Written representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist.

8. Furthermore, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

9. Although written representations provide necessary audit evidence, they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal.

10. Even if management has provided reliable written representation, it does not affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

MANAGEMENT FROM WHOM WRITTEN REPRESENTATIONS REQUESTED

11. The auditor shall request written representations from management with appropriate responsibility for the financial statements and knowledge of the matters concerned.

12. Individuals responsible for the preparation of the financial statements may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles **(see Example 30.2.1)**.

Example 30.2.1

Why do we expect management to have sufficient knowledge of the process followed by the entity in preparing and presenting the financial statements and the assertions therein on which to base the written representations?

However, in some situations, why does management decide to make inquiries of others who participate in preparing and presenting the financial statements and assertions therein matters about which written representations are requested? Give some examples of such individuals and the matters involved.

Answers:

Due to its responsibility for the preparation of the financial statements, and its responsibilities for the conduct of the entity's business, management would be expected to have sufficient knowledge of the process followed by the entity in preparing the financial statements and the assertions therein on which to base the written representations.

of expressing an opinion on the effectiveness of the Group's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in the independent auditor's report is Sze Ching Yiu.

Deloitte Touche Tohmatsu
Certified Public Accountants
Hong Kong
10 September 2020

> the Debt. Given these scope limitations, we were unable to determine whether the directors' estimation of expected credit loss allowance on the Advance and the Debt has followed the Group's accounting policies as detailed in Note 4 to the consolidated financial statements, which are required by Hong Kong Financial Reporting Standard 9 "Financial Instruments".
>
> Recognition of expected credit loss allowance in respect of the Advance or the Debt as at 31 December 2019 found necessary would increase the Group's loss for the year and its net liabilities as at 31 December 2019, and would affect the related disclosures thereof in the consolidated financial statements.

50. In extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements. In such circumstance, the auditor shall disclaim an opinion.

51. When expressing **a disclaimer of opinion** on the financial statements due to the auditor's inability to obtain sufficient appropriate audit evidence, **HKSA 705 (Revised)** requires the auditor to:
    a. Title the Opinion section as "**Disclaimer of Opinion**" and:
        i. State that the auditor does not express an opinion on the financial statements;
        ii. State that, because of the significance of the matters described in the Basis for Disclaimer of Opinion section, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
        iii. Amend the statement required by paragraph 24(b) of HKSA 700 (Revised), which indicates that the financial statements have been audited, to state that the auditor was engaged to audit the financial statements.
    b. Amend the heading "Basis for Opinion" required by **HKSA 700 (Revised)** to "**Basis for Disclaimer of Opinion**", state the reasons for that inability, and not to include the elements required by paragraphs 28(b) (i.e. a reference to the section of the auditor's report where the auditor's responsibilities are described) and 28(d) (i.e. a statement about whether the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion) of HKSA 700 (Revised).
    c. Amend the description of the auditor's responsibilities required by paragraphs 39–41 of **HKSA 700 (Revised)** to include only the following:
        i. A statement that the auditor's responsibility is to conduct an audit of the entity's financial statements in accordance with Hong Kong Standards on Auditing and to issue an auditor's report;
        ii. A statement that, however, because of the matter(s) described in the Basis for Disclaimer of Opinion section, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements; and
        iii. The statement about auditor independence and other ethical responsibilities required by paragraph 28(c) of HKSA 700 (Revised).
    d. Exclude a Key Audit Matters section in accordance with **HKSA 701** or an Other Information section in accordance with **HKSA 720 (Revised)**.

a. An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components.
b. The nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components including, where applicable, the group engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon.
c. Written communications between the group engagement team and the component auditors about the group engagement team's requirements.

ASSOCIATES AND JOINT ARRANGEMENTS

71. The group financial statements may also incorporate the parent's share of results and net assets of associates and/or joint arrangements. As explained before, components can also be associates and joint arrangements.

HKAS 28 "Investments in Associates and Joint Ventures" and **HKFRS 11** "Joint Arrangements" prescribe the accounting treatments in respect of associates and joint arrangements[2].

72. After the convergence to the International Financial Reporting Standards in Hong Kong, the accounting requirements in Hong Kong on associates and joint arrangements not only cover the group financial statements but also individual company financial statements when the entity has no subsidiary.

73. From both the group perspective and individual company perspective, the procedures in applying equity method and proportionate consolidation are similar. The issues and discussion in this chapter can also be applied to associates and joint arrangements in the group financial statements or individual company financial statements. The auditor should additionally consider that:

a. Whether the associates and/or joint arrangements meet the definition in **HKAS 28** and **HKFRS 11**.
b. Any other companies in which the group has shareholdings should be properly treated as associates and/or joint arrangements.
c. Income from each associate and joint arrangements are properly incorporated into the consolidated or individual company income statement.
d. Net assets of the associates and joint arrangements are properly incorporated into the consolidated or individual company balance sheet.
e. Appropriate eliminations have been made for unrealized inter-company profits.
f. Appropriate proportion of post-acquisition profits and reserves retained by the associates are correctly stated.
g. Ensure that the goodwill element in the cost of investment has been properly stated and impairment review has been conducted in accordance with **HKAS 36**.
h. Ensure proper disclosure of the associates and joint arrangements in the notes to the financial statements.

2 For further discussion of the accounting requirements of associates and joint arrangements, refer to Nelson Lam, K. P. Yuen and Jasmine Kwong, *Advanced Financial Reporting: an IFRS Perspective*, McGraw-Hill, 2016, Ch. 5 and 6.

the Directors' report for the year ended 31 December 2020, and contain such information and particulars set out in sections 3(3), 5 and 6 of the Hong Kong Companies (Summary Financial Reports) Regulation, and be approved by the board of directors.

Auditor's Responsibility

Our responsibility is to express an opinion on whether the summary financial report is consistent with the annual financial statements and the auditor's report thereon and the directors' report; and complies with the requirements of Part 2 of the Hong Kong Companies (Summary Financial Reports) Regulation, based on our procedures, which were conducted in accordance with Hong Kong Standard on Auditing 810 (Revised), *Engagements to Report on Summary Financial Statements* issued by the Hong Kong Institute of Certified Public Accountants. We are also required to state whether the auditor's report on the annual financial statements for the year ended 31 December 2020 is qualified or otherwise modified.

Lau and Lam CPA Limited
Certified Public Accountants (Practising)
Kowloon Tong, Hong Kong

15 February 2021

OTHER MATTERS

23. An auditor is also required to alert the readers of the auditor's report in case of any restriction of the distribution or use of the auditor's report on the audited financial statements.

24. **HKSA 810** also sets out the requirements for the auditors to observe on the comparatives, unaudited supplementary information, and other information presented with or distributed together with the summary financial statements. The auditor is also required to alert and take appropriate action, when the management plans to state that the auditor has reported on the summary financial statements but the auditor's report is not accompanied with the summary financial statements.

Summary

25. Summary financial statements refer to historical financial information that is derived from financial statements but that contains less detail than the financial statements, while still providing a structured representation consistent with that provided by the financial statements of the entity's economic resources or obligations at a point in time or the changes therein for a period of time. Different jurisdictions may use different terminology to describe such historical financial information.

26. An auditor may also be asked to report on summary financial statements. **HKSA 810** sets out the auditor's responsibilities relating to such engagement.

Answers:

Relevant considerations for the auditor regarding the appropriateness of the method selected in the circumstances, and, if applicable, the appropriateness of changes from the prior period may include:

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

Example 42.10

Discuss the matters that the auditor may consider when management uses a complex model.

Answers:

Matters that the auditor may consider when management uses a complex model include whether:

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

Example 42.11

The appropriateness of the significant assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the HKFRSs may require management to do so. Design audit procedures to obtain audit evidence about management's intent and ability to carry out certain courses of action.

45 Considering Laws and Regulations

Learning Outcomes

This chapter helps you to understand:

- Management's responsibility to comply with laws and regulations.
- The auditor's responsibility to consider laws and regulations.
- The auditor's consideration of compliance with laws and regulations.
- Audit procedures when non-compliance with laws and regulations is identified or suspected.
- Reporting of non-compliance to those charged with governance, in the auditor's report and to an appropriate authority outside the entity.

Introduction

1. **Chapter 4** discusses the implication of the Companies Ordinance on auditors. This chapter further discusses the responsibility of auditors to consider laws and regulations when performing an audit of financial statements.

2. **HKSA 250 (Revised)** "Consideration of Laws and Regulations in an Audit of Financial Statements" conforms with **ISA 250 (Revised)** "Consideration of Laws and Regulations in an Audit of Financial Statements". Compliance with the requirements of **HKSA 250 (Revised)** ensures compliance with **ISA 250 (Revised)**, except that references to IESBA's Code of Ethics for Professional Accountants are replaced by HKICPA's Code of Ethics for Professional Accountants.

EFFECTS OF LAWS AND REGULATIONS

3. Some clients are in heavily regulated sectors such as banks and chemical companies. However, businesses are generally subject to many laws and regulations in operating areas such as occupational safety and health, and equal employment opportunity.

4. Non-compliance may result in financial consequences such as **fines or litigation** or other consequences for the entity that may have a material effect on the financial statements. In more serious situations, non-compliance may lead to discontinuance of business due to loss of licenses or authorization to operate, etc.

> **Non-compliance** — Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated to the business activities of the entity) by those charged with governance, management or employees of the entity.

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

16. Matters relevant to evaluating the competence, capabilities and objectivity of the auditor's expert include whether that expert's work is subject to:
    a. Technical performance standards or other professional or industry requirements, for example, ethical standards and other membership requirements of a professional body or industry association,
    b. Accreditation standards of a licensing body, or
    c. Requirements imposed by law or regulation.

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

18. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity. These interests and relationships may include:
    a. Financial interests.
    b. Business and personal relationships.
    c. Provision of other services by the expert, including by the organization in the case of an external expert that is an organization.

OBTAINING AN UNDERSTANDING OF THE FIELD OF EXPERTISE OF THE AUDITOR'S EXPERT

19. The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

USER AUDITOR'S OBJECTIVES

5. The objectives of the user auditor, when the user entity uses a service organization, are to obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's system of internal control sufficient to provide an appropriate basis for the identification and assessment of the risks of material misstatement, and to design and perform further audit procedures responsive to those risks.

UNDERSTANDING THE SERVICES PROVIDED BY A SERVICE ORGANIZATION

6. When obtaining an understanding of the entity in accordance with **HKSA 315 (Revised 2019)**, the user auditor shall obtain an understanding of how a user entity uses a service organization in its operations, including:

   a. The **nature of the services provided** by the service organization and the **significance of those services** to the user entity, including the effect thereof on the user entity's internal control. Examples of service organization services that are relevant to the audit include:

      i. Maintenance of the user entity's accounting records.

      ii. Management of assets.

      iii. Initiating, recording or processing transactions as agent of the user entity.

   b. The **nature** and **materiality of the transactions** processed or accounts or financial reporting processes affected by the service organization, and the **degree of interaction** between the activities of the service organization and those of the user entity.

      i. In certain situations, the transactions processed and the accounts affected may not appear to be material to the user entity's financial statements, but the nature of the transactions processed may be significant and the user auditor may determine that an understanding of those controls is necessary in the circumstances.

      ii. A high degree of interaction exists between the activities of the user entity and those at the service organization when the user entity authorizes transactions and the service organization processes and does the accounting of those transactions. In these circumstances, it may be practicable for the user entity to implement effective controls over those transactions.

   c. The **nature of the relationship** between the user entity and the service organization, including the contractual terms for the relevant activities undertaken by the service organization. For example, the information to be provided to the user entity, the indemnification for a performance failure, and the type of report to be provided by the service organization.

7. Information on the nature of the services provided by a service organization may be available from a wide variety of sources, such as:

   a. User manuals;
   b. System overviews;
   c. Technical manuals;