

## Purpose and Features of the Book

*Auditing and Assurance in Hong Kong* explains the practices of auditing and non-auditing engagements using the most updated International and Hong Kong Auditing Standards.

## Key Features

- Coverage of latest auditing and assurance standards, including three chapters on audit of summary financial statements, special purpose financial statements, a single financial statement and a specific element, account or item of a financial statement
- Numerous illustrative examples, figures and diagrams
- Tailor-made illustrative flowcharts 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 57 chapters of this book are structured into the following nine 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 control and practice review.

**Part IV: The Audit Process (Chapters 12 – 29)** provides a review of the whole audit process from planning, risk assessment, auditor's response to assessed risks to the issuance of auditor's report. This part also provides a comprehensive coverage of the audit of major accounting cycles and selected balance sheet items, 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, audit of summary financial statements, audit of special purpose financial statements, and 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 – 49)** examines audit of accounting estimates and related disclosures, other information in documents containing audited financial statements, related parties, consideration of laws and regulations, usage of the work of an expert, service organizations and outsourcing, consideration of the work of internal auditing and audit committees.

**Part VIII: Non-Audit Engagements (Chapters 50 – 53)** discusses compilation and agreed-upon procedures engagements, review and other assurance engagements, prospectus reports and letters, and examination of prospective financial information including profit forecasts.

**Part IX: Current Issues (Chapters 54 – 57)** discusses e-commerce and financial statement audit, WebTrust assurance, business risk and corporate governance.

### **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 lively and stimulate 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 also 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>) 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 care and his colleagues Amy, Samantha and Persephone for their help and support.

Peter Lau and Nelson Lam

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AUDIT OF THE  
INVENTORIES AND  
PRODUCTION CYCLELearning  
Outcomes

This chapter enables you to understand:

- The critical issues in auditing the inventories and production cycle.
- The internal control objectives and key documents of the inventories and production cycle.
- The requirements of physical inventory counting.
- Other auditing requirements in respect of inventories.

## Introduction

1. Inventories are often significant to an entity, including manufacturing companies and retailing companies. While inventories are traded or moved in the operation and some of their attributes, say quantity, quality or condition and value, are not incorporated in the double entry system, inventories are one of the critical audit areas. These attributes are usually the auditor's concerns and the auditor often arranges **physical inventory counting** at year-end to ascertain the quantity and condition of an entity's inventories on hand.

Inventories are also subject to obsolescence, spoilage, damage and theft. The figure attributed to inventories is very important and difficult to compute accurately. Auditors thus normally put more emphasis on inventories by spending relatively more audit time to audit inventories.

2. It should be noted that directors are responsible for ensuring that:
  - a. Inventories are physically in existence and properly protected.
  - b. Quantity and quality of the inventories are correctly ascertained and properly accounted for.
  - c. Inventories are properly valued.
3. The auditor's assessment of inventories in trade will cover:
  - a. **Existence** — Physical inventory counting procedures.
  - b. **Ownership** — Goods in transit, goods at other premises, goods owned by others, reservation of title.
  - c. **Valuation** — Problem of net realizable value.
4. The pertinent HKICPA pronouncements are **HKSA 501** "Audit Evidence — Specific Considerations for Selected Items". Compliance with **HKSA 501** ensures compliance in all material respects with **ISA 501** "Audit Evidence — Specific Considerations for Selected Items" in relation to attendance at physical inventory counting. Attention is also drawn to **HKAS 2** "Inventories" and **HKAS 11** "Construction Contracts".<sup>1</sup>

<sup>1</sup> For further discussion of inventories and construction contracts, refer to Nelson Lam and Peter Lau, *Intermediate Financial Reporting: an IFRS Perspective, Second Edition*, McGraw-Hill, 2012, Ch.9-10.

5. Since the purchasing and payment aspects of inventories have been dealt with in Chapter 23, this chapter discusses the audit of inventories under the following headings:
- Internal control objectives and key documents
  - Categories of inventories and internal controls
  - Physical inventory counting — management's responsibilities
  - Physical inventory counting — auditor's responsibilities
  - Physical observation other than at year-end
  - Attendance not practicable
  - Inventories held by third parties
  - Perpetual inventory system
  - Valuation of inventory
  - Work in progress
  - Overall tests

### INTERNAL CONTROL OBJECTIVES AND KEY DOCUMENTS

6. The **specific audit objectives for inventories** are:

a. <b>Completeness</b>	All inventories that should have been recorded have been recorded.
b. <b>Existence</b>	Inventories that have been recorded exist.
c. <b>Rights</b>	The entity holds or controls the right to inventories.
d. <b>Valuation</b>	Inventories have been included in the financial statements at appropriate amount.
e. <b>Classification</b>	Inventories have been properly classified.
f. <b>Cut-off</b>	Inventories have been properly recorded in the correct accounting period.
g. <b>Posting and Summarization</b>	Inventories have been properly included in the sub-ledgers and are correctly summarized.

7. The **key documents** for purchasing and payment aspects of inventories have been dealt with in Chapter 23. The following items are mainly related to inventory counting and valuation.

a. <b>Inventory record</b>	A record indicating information such as product number, product description, quantity on hand, unit cost, total value, date of last purchase, supplier's code, date of last sale and physical counting variance.
b. <b>Inventory count sheet</b>	A sheet indicating the product number, product description, actual quantity per inventory count, and condition of the inventory for each of inventory items listed in the sheet.

c. <b>Inventory count tag</b>	A tag indicating the product number, product description, and actual quantity per inventory count, and condition of the inventory for the inventory item are specified in the tag.
d. <b>Final inventory listing</b>	This is actually the finalized inventory listing of all inventories. The total amount is the financial statement figure for inventories.

### CATEGORIES OF INVENTORIES AND INTERNAL CONTROLS

8. **HKAS 2** defines inventories as assets held for sale in the ordinary course of business, in the process of production for such sale, or in the form of materials or supplies to be consumed in the production process or in the rendering of services.
9. Inventories can encompass:
  - a. Goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale.
  - b. Finished goods produced.
  - c. Work in progress being produced.
  - d. Raw materials and supplies awaiting use in the production process.
  - e. Consumable stores supplies, such as oils, fuels, spare parts, etc.
  - f. Returnable containers.
10. The following are **key internal controls** to ensure that inventories are adequately protected against loss or misuse:
  - a. **Segregation of duties** should be maintained on inventory records, custody of inventories and authorization of delivery and receipt of inventories.
  - b. **Inventory records**
    - i. Inventory records should be properly maintained by independent staff who cannot order purchase or receipt of inventories and has no custody of the inventories.
    - ii. Periodical comparison of the inventory records with the actual physical inventories, say the results of the periodic physical inventory counting, should be performed by independent staff.
    - iii. All the discrepancies should be investigated and properly followed up.
    - iv. Inventories held by third parties, such as consignment goods or inventories held in public warehouse, should be properly recorded.
  - c. **Custody of inventories and controls in warehouse**
    - i. Proper **physical security**, such as security locks, fire alarm system and access restrictions, should be imposed on the warehouse, and independent staff is responsible for the inventory keeping.
    - ii. Different inventories should be stored with different arrangements, such as raw materials, loose tools, work in progress, and finished goods, should be separately considered and identified.

- iii. Inventories that may be subject to physical deterioration or damage (such as food or glass) should be protected with proper arrangements in the warehouse, for example, constant temperature arrangement, and special packages. All significant physical deterioration or damages on inventories should be properly investigated and followed up.
  - iv. Control procedures on receipt of goods (see Chapter 23) and despatch of goods (see Chapter 22) should be followed and regularly be checked by independent staff. Pre-numbered forms should be used and all movements should be properly documented.
  - v. Periodical physical inventory counting should be performed and surprise inventory counting can also be arranged. All the discrepancies should be investigated and properly followed up.
  - vi. Inventories held for third parties and returned inventories should be separately stored, and regular checking or investigation should be performed.
- d. Proper **authorization** should be required and documented on all inventory movements, write-off and disposal. Maximum inventories level kept in warehouse and minimum re-order level should be set and coached by the relevant responsible staff.

### PHYSICAL INVENTORY COUNTING – MANAGEMENT'S RESPONSIBILITIES

11. The Companies Ordinance requires companies to keep proper accounting records. Such proper accounting records include statements of physical inventory counting.  
**HKSA 501** also states that management ordinarily establishes procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system.
12. Physical inventory counting is an important aspect of internal control because it:
  - a. Provides confirmation to management on the quantity and condition of the company's inventories.
  - b. Assists management in their duty to safeguard the assets of the company.
  - c. Is an important factor in the attainment of truth and fairness in financial statements.
13. Since inventories quantities are not derived from the double entry system, it is not appropriate to place complete reliance on inventory records because errors may still occur in a good internal control system.
14. A good set of physical inventory counting procedures will have the following characteristics:
  - a. Proper organization and planning on physical inventory counting are required in order to achieve the physical inventory counting objective.
  - b. Proper person is nominated to be responsible for overall control of each aspect of the physical inventory counting at each location.
  - c. Composition of each inventory counting teams is properly planned with sufficient and competent staff and each staff is informed in advance.

- d. Distribute physical inventory counting instructions (in writing) to all staff and locations involved as soon as possible. Coach staff properly and consider their feedback and inquiry.
- e. Physical arrangement of inventories in each location should be proper for counting, for example, inventories of each location should be divided into manageable areas, and each area should be covered and counted by the assigned team of staff.
- f. Methods of determining and checking quantities should be established, for example, counting, weighing, measuring and/or checking.
- g. Identification of high value items should be counted.
- h. Defective, damaged, obsolete and slow moving inventories should be properly located and listed in the counting record, for example, put the obsolete inventory items on a specified place in the warehouse.
- i. Identification of inventory held on behalf of third parties in each location and identification of property, plant and equipment and loose tools in each location.
- j. Inventories held for third parties or not belonged to the entity should be properly located and listed in the counting record, for example, consignment goods received or inventories pledged for loans or banking facilities.
- k. The issue of blank inventory count sheets and the return of completed and unused inventory count sheets should be properly controlled and documented.
- l. Sequence checking is performed on the inventory count sheets.
- m. Establishment of proper cut-off arrangements for goods received and delivered. For example, the last number of goods received notes and of goods despatch notes should be documented.
- n. Avoid inventory movement during the counting and, if necessary, the movement should be properly controlled and documented, for example, recording the details of the raw material requested by the production departments during the counting period.
- o. Goods with special problems or other issues should be properly located and handled.
- p. Ensure that all inventories are counted only once (e.g. by the use of tag and making sure all inventory items are tagged only once) and avoid duplication of counting (e.g. marking inventories or bins after counting, or attaching stock sheet to the inventories)
- q. Identification of work in progress, which should be physically verified at the same occasion.
- r. The discrepancies noted in the physical inventory counting (i.e. counting variance) should be investigated, and the relevant accounting records should be amended. In addition, the implication on the internal control should be considered.

### PHYSICAL INVENTORY COUNTING – THE AUDITOR'S RESPONSIBILITIES

15. **HKSA 501** requires that, when inventory is material to the financial statements, the auditor is required to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

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## RELATED PARTIES



## Learning Outcomes

This chapter enables you to understand:

- Management's responsibility for related party relationships and transactions.
- Auditor's responsibility for related party relationships and transactions.
- Risk assessment procedures and related activities regarding related party relationships and transactions.
- Identification and assessment of and response to the risks of material misstatement associated with related party relationships and transactions.
- Evaluation of the accounting for and disclosure of identified related party relationships and transactions.
- Written representations from management and communication with those charged with governance regarding related party relationships and transactions.

## Introduction

1. Management is responsible for identifying and disclosing related party relationships and transactions. Even though related parties and transactions between such parties are considered ordinary features of business, the auditor needs to be aware of them because:
  - a. **HKAS 24** requires disclosure in the financial statements of certain related party relationships and transactions (**see Real-life Case 44.1**).
  - b. Related party relationships and transactions may affect the financial statements. For example, Inland Revenue Ordinance has specific provisions for related parties and transactions between such parties, thus affecting an entity's tax liability and expense.
  - c. Audit evidence obtained from or created by unrelated third parties are in general more reliable than audit evidence obtained from or created by related parties.
  - d. Related party transactions may be motivated by things other than ordinary business considerations, for example, tax avoidance through transfer pricing or even fraud.

## Real-life Case 44.1: Cheung Kong (Holdings) Limited

Cheung Kong and its subsidiaries (the "Group") are principally engaged in the property development and investment, hotel and serviced suite operation, property and project management and investment in securities. The Group disclosed the following related party transactions in its 2010 annual report:

- During the year and in the ordinary course of business, the Group undertook various joint venture projects with related parties, including the Chairman, Mr. Li Ka-shing, and Hutchison Whampoa Limited, on normal commercial terms. Advances were made to/received from and guarantees were provided for these joint venture projects on a pro rata basis. Advances made/received by the Group at the balance sheet date were disclosed as amount due from/to associates and jointly controlled entities in notes (11) and (12). Guarantees provided by the Group for bank loans utilized by jointly controlled entities at the balance sheet date were disclosed in note (25). Other than the aforementioned, there were no other significant related party transactions requiring disclosure in the financial statements.

2. **HKSA 550** "Related Parties" deals with the auditor's responsibilities regarding related party relationships and transactions when performing an audit of financial statements. Specifically, it expands on how HKSA 315, HKSA 330 and HKSA 240 are to be applied in relation to risks of material misstatement associated with related party relationships and transactions. **HKSA 550** conforms with **ISA 550** "Related Parties". Compliance with the requirements of **HKSA 550** also ensures compliance with the requirements of **ISA 550**.

**Related party** — in accordance with HKAS 24, a related party is a person or entity that is related to the entity that is preparing its financial statements (the "reporting entity").

- A person or a close member of that person's family is related to a reporting entity if that person:
  - has control or joint control over the reporting entity;
  - has significant influence over the reporting entity; or
  - is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.
- An entity is related to a reporting entity if any of the following conditions applies:
  - The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others);
  - One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
  - Both entities are joint ventures of the same third party.
  - One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
  - The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.
  - The entity is controlled or jointly controlled by a person identified in (a).
  - A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

## NATURE OF RELATED PARTY RELATIONSHIPS AND TRANSACTIONS

3. Many related party transactions are in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties.
4. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:
  - a. Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions (**see Real-life Case 44.2**).
  - b. Information systems may be ineffective in identifying or summarizing transactions and outstanding balances between an entity and its related parties.
  - c. Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.
  - d. The entity is short of sufficient working capital or credit to continue the business, has a desire for continued favourable earnings record, express an overly optimistic earnings forecast, has idle production capacity, encounters significant litigation, is engaged in a declining industry characterized by extensive business failures, or is engaged in a high-technology industry characterized by significant obsolescence dangers.

### Real-life Case 44.2: Hong Kong and China Gas Company Limited

Hong Kong and China Gas Company Limited is principally engaged in the production, distribution and marketing of gas, water and related activities in Hong Kong and the People's Republic of China. The Company made the following public announcement on continuing connected transactions on supply of coalbed methane by Qinshui Lanyan to Shanxi JV on 1 Jan 2009 in accordance with the Listing Rules of the Stock Exchange of Hong Kong Limited:

- The Board announces that on 31st December 2008, Shanxi JV (a non-wholly owned subsidiary of the Company) as purchaser entered into the Coalbed Methane Contracts with Qinshui Lanyan as seller and Shanxi Jincheng as warrantor, pursuant to which Qinshui Lanyan agreed to supply coalbed methane to Shanxi JV each for terms of 30 years.
- Shanxi Jincheng is a substantial shareholder of Shanxi JV and is therefore a connected person of the Company. As Qinshui Lanyan is a non-wholly owned subsidiary of Shanxi Jincheng, it is an associate of Shanxi Jincheng and is therefore also a connected person of the Company. Accordingly, the transactions contemplated under the Coalbed Methane Contracts constitute a continuing connected transaction for the Company under Chapter 14A of the Listing Rules.
- Since the applicable percentage ratios calculated with reference to the Annual Cap of the above **continuing connected transaction** are less than 2.5% but more than 0.1%, the above continuing connected transaction is only subject to the reporting and announcement requirements, but is exempt from the independent shareholders' approval requirements under Chapter 14A of the Listing Rules.

**Percentage Ratios under Chapter 14 and 14A of the Listing Rules** — The percentage ratios are the figures, expressed as percentages resulting from each of the following calculations:

- **Assets ratio** — the total assets which are the subject of the transaction divided by the total assets of the listed issuer;
- **Profits ratio** — the profits attributable to the assets which are the subject of the transaction divided by the profits of the listed issuer;
- **Revenue ratio** — the revenue attributable to the assets which are the subject of the transaction divided by the revenue of the listed issuer;
- **Consideration ratio** — the consideration divided by the total market capitalization of the listed issuer. The total market capitalization is the average closing price of the listed issuer's securities as stated in the Exchange's daily quotations sheets for the five business days immediately preceding the date of the transaction; and
- **Equity capital ratio** — the nominal value of the listed issuer's equity capital issued as consideration divided by the nominal value of the listed issuer's issued equity capital immediately before the transaction.

## MANAGEMENT'S RESPONSIBILITY

5. It is **management's responsibility** to identify and disclose related party relationships and transactions. In this regard, management shall implement adequate internal control to ensure that transactions with related parties are appropriately identified in the information system and disclosed in the financial statements.

## AUDITOR'S RESPONSIBILITY

6. The auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with **HKAS 24**.
7. The auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to conclude whether the financial statements, insofar as they are affected by those relationships and transactions, achieve true and fair presentation.
8. Such an understanding is also relevant to the auditor's evaluation of whether one or more fraud risk factors are present as required by HKSA 240, as fraud may be more easily committed through related parties.
9. In the context of related parties, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater because:
  - a. Management may be unaware of the existence of all related party relationships and transactions.
  - b. Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

10. Given the potential for undisclosed related party relationships and transactions, planning and performing the audit with professional skepticism as required by **HKSA 200** is particularly important in this context.

### AUDITOR'S OBJECTIVES

11. The objectives of the auditor are thus:
- a. to obtain an understanding of related party relationships and transactions sufficient to:
    - i. Recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
    - ii. Conclude whether the financial statements, insofar as they are affected by those relationships and transactions, achieve true and fair presentation; and
  - b. to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with **HKAS 24**.

### RISK ASSESSMENT PROCEDURES AND RELATED ACTIVITIES

12. As part of the risk assessment procedures, the auditor shall perform the audit procedures and related activities to obtain information relevant to identifying the risks of material misstatement associated with related party relationships and transactions.

#### Understanding the Entity's Related Party Relationships and Transactions

13. The engagement team discussion, as required by **HKSA 315** and **HKSA 240**, shall include specific consideration of the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions (see **Example 44.1**).

#### Example 44.1

What are the matters that may be addressed in the discussion among the engagement team members?

Answers:

Matters that may be addressed in the discussion among the engagement team members include:

- The nature and extent of the entity's relationships and transactions with related parties (using, for example, the auditor's record of identified related parties updated after each audit).
- An emphasis on the importance of maintaining an attitude of professional skepticism throughout the audit regarding the potential for material misstatement associated with related party relationships and transactions.

- The circumstances or conditions of the entity that may indicate the existence of related party relationships or transactions that management has not identified or disclosed to the auditor. For example, a complex organizational structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system.
  - The records or documents that may indicate the existence of related party relationships or transactions.
  - The importance that management and those charged with governance attach to the identification of, appropriate accounting for, and disclosure of related party relationships and transactions, and the related risk of management override of relevant controls.
14. The discussion in the context of fraud may include specific consideration of how related parties may be involved in fraud. For example, how transactions between the entity and a known business partner of a key member of management could be arranged to facilitate misappropriation of the entity's assets.
15. The auditor shall inquire of management regarding:
- a. The identity of the entity's related parties, including changes from the prior period.
    - i. For recurring engagements, making the inquiries provides a basis for comparing the information supplied by management with the auditor's record of related parties noted in previous audits.
    - ii. Information regarding the identity of the entity's related parties may also be obtained through inquiries of management during the engagement acceptance or continuance process.
  - b. The nature of the relationships between the entity and these related parties; and
  - c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.
16. The auditor shall inquire of management and others within the entity (e.g. those charged with governance and internal auditors) and perform other risk assessment procedures considered appropriate to obtain an understanding of the controls, if any, that management has established to **(see Example 44.2)**:
- a. Identify, account for, and disclose related party relationships and transactions in accordance with HKAS 24;
  - b. Authorize and approve significant transactions and arrangements with related parties; and
  - c. Authorize and approve significant transactions and arrangements outside the normal course of business **(see Example 44.3)**.

#### Example 44.2

In meeting the HKSA 315 requirement to obtain an understanding of the control environment, the auditor may consider features of the control environment relevant to mitigating the risks of material misstatement associated with related party relationships and transactions. Give examples of these features of the control environment.